

# Washington International Law Journal

---

Volume 10 | Number 3

---

5-1-2001

## Tax Treatments for Distressed Bank Loans: A Comparative Study of the United States and Japanese Legal Systems

Yo Ota

Follow this and additional works at: <https://digitalcommons.law.uw.edu/wilj>



Part of the [Banking and Finance Law Commons](#), and the [Comparative and Foreign Law Commons](#)

---

### Recommended Citation

Yo Ota, *Tax Treatments for Distressed Bank Loans: A Comparative Study of the United States and Japanese Legal Systems*, 10 Pac. Rim L & Pol'y J. 543 (2001).

Available at: <https://digitalcommons.law.uw.edu/wilj/vol10/iss3/3>

This Article is brought to you for free and open access by the Law Reviews and Journals at UW Law Digital Commons. It has been accepted for inclusion in Washington International Law Journal by an authorized editor of UW Law Digital Commons. For more information, please contact [cnyberg@uw.edu](mailto:cnyberg@uw.edu).

# TAX TREATMENTS FOR DISTRESSED BANK LOANS: A COMPARATIVE STUDY OF THE UNITED STATES AND JAPANESE LEGAL SYSTEMS

Yo Ota<sup>†</sup>

**Abstract:** A number of commentators in Japan have argued that tax treatments for distressed bank loans seem to be more generous in Japan than in the United States, and that, in contrast to Japan, the United States does not allow any deduction for loan loss reserves. However, such arguments have not been based upon a careful analysis of case law and actual tax authority practices. This Article presents a comparative study of the tax treatments for distressed bank loans in the United States and Japan. It analyzes corporate income tax legislation, administrative practices and case law in the 1980s and 1990s and explores several major differences between the United States and Japan with respect to the treatment of distressed bank loans. Based on this analysis, this Article challenges the traditional view of comparative tax treatments in these two countries and contends that Japanese tax treatments provide insufficient incentives for banks to expedite the disposal of distressed loans. Finally, this Article suggests possible legislative approaches for establishing a workable legal scheme that provides more economically neutral and internationally harmonized tax treatments for distressed bank loans in Japan.

I. INTRODUCTION.....	545
II. BASIC TAX TREATMENTS FOR DISTRESSED BANK LOANS IN THE UNITED STATES AND JAPAN .....	548
A. <i>Basic Structures of Corporate Income Tax in the United States and Japan</i> .....	548
B. <i>Basic Treatments for Distressed Bank Loans</i> .....	553
1. <i>Under the U.S. Tax System</i> .....	553
2. <i>Under the Japanese Tax System</i> .....	554
III. MAJOR DIFFERENCES BETWEEN THE U.S. AND THE JAPANESE TAX SYSTEMS .....	556
A. <i>Timing of Deductions for Tax Purposes</i> .....	556
1. <i>The Different Implications of the "Conformity Rule" Between the United States and Japan</i> .....	556
a. <i>Under the U.S. tax system</i> .....	556
b. <i>Under the Japanese tax system</i> .....	558
2. <i>General Loan Loss Reserve</i> .....	560
a. <i>Under the U.S. tax system</i> .....	560
b. <i>Under the Japanese tax system</i> .....	562

---

<sup>†</sup> Associate Senior Counsellor at the Office of Senior Counsel, Civil Affairs Bureau, Ministry of Justice (Tokyo, Japan). LL.B. University of Tokyo, Faculty of Law, 1991; LL.M. Harvard Law School 2000. Admitted to practice law in Japan (1993) and the State of New York (2001). Nishimura & Partners (Tokyo, Japan), 1993-99; Debevoise & Plimpton (New York), 2000-01. The author would like to thank Professor J. Mark Ramseyer at Harvard Law School and Gary E. Murphy, Esq. at Debevoise & Plimpton for their invaluable comments on earlier drafts.

B. Partial Worthlessness of a Loan .....	565
1. Partial Worthlessness of a Loan and Other Issues Regarding the Timing of Deductions under Japanese Tax Treatment.....	565
a. Special depreciation account and the CCPC.....	565
b. An introduction to the justification of NTA's policies .....	568
c. Influences and impact of the Necessity of Liquidation theory on on Japanese tax treatments for distressed loans.....	573
2. Partial Worthlessness of a Loan and Other Issues Regarding Timing of Deductions under U.S. Tax Policy.....	574
a. Tax treatments for partial worthlessness of a loan in the United States .....	574
b. The inapplicability of the Necessity of Liquidation theory under U.S. tax law and practices .....	575
C. Adoption of the "Deferred Tax Assets" Concept in Accounting .....	580
D. Mark-to-Market Rule for the Assessment of Financial Assets .....	585
1. U.S. Legislation.....	585
2. Japanese Legislation.....	589
E. The inapplicability of the Rule for Delinquent Interest .....	591
1. Under Japanese Tax Treatments .....	591
2. Under U.S. Tax Treatments .....	593
3. Analysis .....	595
F. Restructuring of Troubled Debts .....	596
1. Under U.S. Tax Treatments .....	596
2. Under Japanese Tax Treatments .....	600
G. NOL Carryback for Commercial Banks and Tax Treatments Specifically Focusing on Banks .....	603
1. U.S. Legislation.....	603
a. The original enactment of the ten-year NOL carryback for commercial banks .....	603
b. Amendment of the ten-year NOL carryback .....	605
c. Reactions to the repeal of the ten-year NOL carryback .....	607
d. Conclusions.....	607
2. Japanese Legislation.....	608
a. Suspension of refund of corporate income tax by using the net- loss carryback since 1992 .....	608
b. Anti-major-bank taxation by the Tokyo metropolitan government .....	609
IV. DID THE JAPANESE TAX SYSTEM FRUSTRATE THE PROMPT DISPOSITION OF DISTRESSED BANK LOANS? .....	613
V. CONCLUSION.....	615

## I. INTRODUCTION

The Japanese media has repeatedly stated that the 1990s was the "lost decade" for Japan.<sup>1</sup> On the last business day of 1989,<sup>2</sup> the Dow-Jones Industrial Average ("Dow Jones Average") in New York City registered only 2753, while on the Nikkei Average 225 ("Nikkei Average") the standard stock price index for the Tokyo Stock Exchange, peaked at 38,915. In sharp contrast, on the last business day of 1999<sup>3</sup> the *Dow-Jones Average* reported a high closing figure of 11,453 and the *Nikkei Average* closed at only 18,934. Of course, the United States suffered serious financial setbacks in the 1980s. Nine hundred twelve savings and loan institutions ("S&Ls") went bankrupt between 1981 and 1983.<sup>4</sup> Further, a second severe crisis hit the U.S. financial industry between 1986 and 1992.<sup>5</sup> As a result, 1142 S&Ls and 1395 commercial banks closed, and the U.S. government spent nearly \$125 billion to manage these crises.<sup>6</sup>

The Japanese financial crisis of the 1990s, however, was even more devastating in its scale and nature than that experienced by the United States. By the end of 1998, three of twenty-one Japanese money-center banks had become insolvent and were reorganized by the government,<sup>7</sup> and the fourth<sup>8</sup> and seventh<sup>9</sup> largest securities firms had gone bankrupt. As a result, the Japanese government injected approximately 1.8 trillion yen (0.4% of Gross Domestic Product ("GDP")) into twenty-one major commercial banks in March of 1998.<sup>10</sup> In October 1998, the Japanese government set aside sixty trillion yen (approximately 12% of the GDP) to strengthen the banking sector. Of this amount, twenty-five trillion yen was earmarked for recapitalizing weak but solvent banks, eighteen trillion yen for dealing with insolvent banks through nationalization and liquidation, and seventeen trillion yen for full deposit protection of insolvent banks to prevent the

<sup>1</sup> See, e.g., USHIO SHIOTA, KIN'YŪ ARJIGOKU [THE FINANCIAL DOODLEBUG] 340 (1999).

<sup>2</sup> Dec. 29, 1989.

<sup>3</sup> Dec. 30, 1999.

<sup>4</sup> See, e.g., SHIOTA, *supra* note 1, at 243.

<sup>5</sup> *Id.*

<sup>6</sup> See, e.g., AKIYOSHI HORIUCHI, KIN'YŪ SHISUTEMU NO MIRAI: FURYŌ SAIKEN MONDAI TO BIGGU BAN [THE FUTURE OF THE FINANCIAL SYSTEM: DISTRESSED LOAN PROBLEM AND THE "BIG BANG"] 30 (1998).

<sup>7</sup> These three were: (1) the Hokkaido Takushoku Bank, Ltd.; (2) the Long-Term Credit Bank of Japan Ltd.; and (3) the Nippon Credit Bank Ltd.

<sup>8</sup> Yamaichi Securities Co., Ltd.

<sup>9</sup> Sanyo Securities Co., Ltd.

<sup>10</sup> See, e.g., *Tōkyō Mitsubishi Gin, Getsu-nai 1000 Oku En* [The Bank of Tokyo-Mitsubishi plans to repay 100 billion yen to the Government by the end of February], NIHON KEIZAI SHINBUN, morning edition, Feb. 22, 2000, at 7 [hereinafter *Tokyo-Mitsubishi*].

Japanese economy from plunging into a serious financial panic.<sup>11</sup> Subsequently, the Japanese government injected a total of 7.5 trillion yen into fifteen money-center banks for their recapitalization.<sup>12</sup>

Losses resulting from the collapse of the Japanese "bubble" economy amounted to 1285 trillion yen (730 trillion yen in real property and 555 trillion yen in stocks).<sup>13</sup> This figure roughly equaled Japan's GDP for a period of two and a half years.<sup>14</sup> This catastrophe resulted in a loss of assets far greater than the asset losses experienced by Japan during World War II.<sup>15</sup> The collapse of the Japanese economy and its marked contrast with the performance of the U.S. economy in the 1990s has caused many Japanese economists and journalists to dub this period as "Japan's second defeat."<sup>16</sup>

Though economists offer differing hypotheses about the reasons for this Japanese banking crisis and depression,<sup>17</sup> there seems to be consensus on one issue: the decisive factor that prolonged this depression was the delay by Japanese financial institutions in disposing of distressed loans.<sup>18</sup>

Although there are many explanations as to how the delay led the Japanese economy to an extended depression, some economists focus on how such a delay unnecessarily "taps-out" cash.<sup>19</sup> If a bank does not charge off or establish loan loss reserves for its distressed loans on a timely basis, its profits will be overstated in its financial statements.<sup>20</sup> Overstated profits, in turn, lead to higher corporate income taxes than if appropriate accounting practices were in place to account for bad debt.<sup>21</sup> Also, higher profits increase the pressure to pay dividends and officer bonuses.<sup>22</sup> Thus, Japanese banks' delay in disposing of their distressed loans in the 1990s caused them to tap out a huge amount of previously retained earnings. As a result, the deterioration of their capital base, principally caused by the drastic decline in

---

<sup>11</sup> See Akihiro Kanaya & David Woo, *The Japanese Banking Crisis of the 1990s: Sources and Lessons*, INT'L MONETARY FUND WORKING PAPER No. 7, at 32 (2000).

<sup>12</sup> See *Tokyo-Mitsubishi*, *supra* note 10, at 7.

<sup>13</sup> See YOSHIMASA NISHIMURA, KIN'YO GYŌSEI NO HAIIN [CAUSES OF THE FAILURES OF THE SUPERVISION OVER FINANCIAL INSTITUTIONS] 247 (1999).

<sup>14</sup> See *id.*

<sup>15</sup> See *id.* The aggregate losses suffered by Japan during World War II was roughly equivalent to Japan's GDP for only a one year period in the 1940s. *Id.*

<sup>16</sup> See NISHIMURA, *supra* note 13, at 5.

<sup>17</sup> For example, economists at the IMF have argued that weak corporate governance and regulatory forbearance stifled any incentive for meaningful restructuring of banks as well as their corporate borrowers and that these two factors contributed to what might have been an unnecessary prolongation of the crisis. See Kanaya & Woo, *supra* note 11, at 5.

<sup>18</sup> See, e.g., HORIUCHI, *supra* note 6, at 33, 54.

<sup>19</sup> See, e.g., *id.* at 21-22, 53-54.

<sup>20</sup> See, e.g., *id.* at 21-22.

<sup>21</sup> See *id.*

<sup>22</sup> See *id.*

stock and real estate prices, was expedited and enhanced. This tapping-out process was amplified by the unique Japanese corporate practice of paying consistent, though not high, dividends regardless of company performance.<sup>23</sup>

As a result, from 1991 through 1997,<sup>24</sup> Japanese banks had paid out, in the aggregate, approximately 5.5 trillion yen in dividends and 9.2 trillion yen in taxes.<sup>25</sup> Such dividends and taxes were paid out despite the fact that, even by the Ministry of Finance's ("MOF") modest estimates, the total amount of distressed loans held by the twenty-one money-center banks in Japan as of the end of September 1992 had already reached 12.3 trillion yen.<sup>26</sup>

This erosion of Japanese bank capital bases of contributed to cutbacks on lending, as banks began to fail the capital ratio requirement of the International Convergence of Capital Measurement and Capital Standards ("Basle Capital Accord.")<sup>27</sup> These cutbacks in lending meant less funds were available for possible purchases of real estate during this period.<sup>28</sup> This led to the deterioration of the Japanese real estate market, and made it difficult for banks to liquidate the collateral securing their distressed loans, which was mostly in the form of real estate.<sup>29</sup> This liquidation problem in turn amplified the deterioration of the "market" value of loan assets held by

<sup>23</sup> See Kanaya & Woo, *supra* note 11, at 27. This practice was possibly attributable to the belief (shared by the bank regulatory authorities) that the suspension of dividends would be a signal of distress and would lead to a sharp fall in bank stock prices or possibly even to a run on the banks. *Id.*

<sup>24</sup> 1997 was the year in which the Japanese bank regulatory agency officially declared that the total amount of distressed loans held by Japanese national banks reached 76.7 trillion yen. TSUNEHICO ŌSHIMA & YOSHIAKI NISHIMURA, FURYO SAIKEN RYŪDŌ-KA NO SHIKUMI TO ZEIMU [FRAMEWORK OF LIQUIDATION OF AND TAX TREATMENTS FOR DISTRESSED LOANS] 68 (1999).

<sup>25</sup> See Kanaya & Woo, *supra* note 11, at 41 tbl. 10.

<sup>26</sup> NISHIMURA, *supra* note 13, at 119.

<sup>27</sup> Agreement on International Convergence of Capital Measurement and Capital Standards, July 1988, 30 I.L.M. 967 [hereinafter *Basle Capital Accord*]. For the detailed explanation of this Accord, see HAL S. SCOTT & SHINSAKU IWAHARA, IN SEARCH OF A LEVEL PLAYING FIELD: THE IMPLEMENTATION OF THE BASLE CAPITAL ACCORD IN JAPAN AND THE UNITED STATES (Group of Thirty, Occasional Papers No. 46, 1994). This book was translated into Japanese by Prof. Shinsaku Iwahara. See Shinsaku Iwahara & Hal S. Scott, *Ginkō no Jikoshihon Hiritsu Kisei ni kansuru Bāzeru Gōi no Nichibei ni okeru Gutaika I* [In Search of a Level Playing Field: the Implement of the Basle Capital Accord in Japan and the United States I], 1354 SHŌJI HŌMU 49 (1994); Shinsaku Iwahara & Hal S. Scott, *Ginkō no Jikoshihon Hiritsu Kisei ni kansuru Bāzeru Gōi no Nichibei ni okeru Gutaika II* [In Search of a Level Playing Field: the Implement of the Basle Capital Accord in Japan and the United States II], 1355 SHŌJI HŌMU 2 (1994); Shinsaku Iwahara & Hal S. Scott, *Ginkō no Jikoshihon Hiritsu Kisei ni kansuru Bāzeru Gōi no Nichibei ni okeru Gutaika III* [In Search of a Level Playing Field: the Implement of the Basle Capital Accord in Japan and the United States III], 1356 SHŌJI HŌMU 14 (1994) [Iwahara & Scott III]; Shinsaku Iwahara & Hal S. Scott, *Ginkō no Jikoshihon Hiritsu Kisei ni kansuru Bāzeru Gōi no Nichibei ni okeru Gutaika IV* [In Search of a Level Playing Field: the Implement of the Basle Capital Accord in Japan and the United States IV], 1357 SHŌJI HŌMU 19 (1994) [hereinafter Iwahara & Scott IV].

<sup>28</sup> See SHIOTA, *supra* note 1, 252-53.

<sup>29</sup> See Shūzo Noda, *Furyō Saiken no Kashidaore Sonshitsu* [Charge-off of Distressed Loans], 16 ZEIMU JIREI KENKYŌ 31, 47 (1993).

banks and accelerated the erosion of their capital bases, which exacerbated the "credit crunch" phenomenon.<sup>30</sup> As a result of this vicious circle, the financial condition of Japanese banks throughout the 1990s was significantly undermined and the depression of the Japanese economy became increasingly serious. Based upon these observations, many economists argue that the delay in disposing of distressed loans contributed, at least partially, to the prolonging of the Japanese economy's depression.<sup>31</sup>

While this Article is not intended to question or examine the existence or processes of this vicious circle, it establishes that Japanese tax treatments for the disposition of distressed bank loans did not offer sufficient incentives to Japanese banks, especially when compared to those offered by the United States. This comparative study of the tax treatments in the United States and Japan is primarily designed to illustrate the significant differences in the tax treatments afforded by these two countries. This Article therefore explores several major differences in tax treatments between the United States and Japan with respect to the disposition of distressed bank loans. Part II provides some background on how the U.S. and Japanese tax systems treat distressed bank loans. Part III outlines the major differences between the United States' and Japan's treatment of distressed loans. Part IV discusses the relative insufficiency of incentives given to Japanese banks to dispose of their distressed loans and suggests possible legislative approaches for establishing a workable legal scheme for more "harmonized" and economically neutral tax treatments for distressed bank loans in Japan. Emphasis is placed on legislation, administrative practice, and case law relating to corporate income tax in the 1980s and 1990s in connection with the bank loans in question.

## II. BASIC TAX TREATMENTS FOR DISTRESSED BANK LOANS IN THE UNITED STATES AND JAPAN

### A. *Basic Structures of Corporate Income Tax in the United States and Japan*

The United States and Japan differ in the legislative structure of their income tax laws. In the United States, all federal domestic taxes are set forth in a single code called the Internal Revenue Code of 1986 ("IRC"). In

---

<sup>30</sup> See NISHIMURA, *supra* note 13, at 86-87, 223-26. "Credit Crunch Phenomenon" is the phenomenon in which many banks and other financial institutions become extremely reluctant to make new or additional loans and are moving to withdraw their existing loans. *Id.*

<sup>31</sup> See, e.g., HORIUCHI, *supra* note 6, at 33, 54.

Japan, it is a general principle of legislation to enact separate statutes for each specific national tax.<sup>32</sup> Further, the Japanese national corporate income tax system is independent from the national individual income tax system. Accordingly, the Corporation Tax Act<sup>33</sup> ("CTA") governs the national corporate income tax, and the Income Tax Act ("ITA"),<sup>34</sup> controls income tax for individuals.

In spite of this difference in legislative structure, the national corporate income tax provisions of the United States and those of Japan share many common features. Under both systems, corporations ordinarily may not deduct the dividends they pay to their shareholders. As a result, corporate income is subject to what has been called a "double-tax;" the funds are taxed once at the corporate level and again as "income" distributed to shareholders via dividends.<sup>35</sup> Both the United States and Japan maintain a global system<sup>36</sup> and do not adopt a schedular system<sup>37</sup> for national corporate income tax.<sup>38</sup> In other words, both systems aggregate all income and expenses and then tax the net. Thus, in both Japan and the United States, the amount of tax payable by a corporation is calculated in its basic form using the following formula:

$$\begin{aligned} & (\text{taxable income attributable to taxpayer corp.}) \times (\text{tax rates}) \\ & - \frac{(\text{applicable tax credits})}{\text{amount of tax payable}}^{39} \end{aligned}$$

It is widely accepted that both the United States and Japanese corporate income tax system have adopted the *Haig-Simons*<sup>40</sup> definition of

<sup>32</sup> HIROSHI KANEKO, SOZEI HÔ [TAX LAW] 105 (7th ed. 1999).

<sup>33</sup> Hôjin-zei hô [Corporation Tax Act], Law No. 34 of 1965 [hereinafter CTA 1965] (Japan).

<sup>34</sup> Shotoku-zei hô [Income Tax Act], Law No. 33 of 1965 (Japan).

<sup>35</sup> BERNARD WOLFMAN, FEDERAL INCOME TAXATION OF CORPORATE ENTERPRISE 3 (3d ed. 1990). KANEKO, *supra* note 32, at 232, 238. It should be noted, however, that since Japanese corporations have traditionally had modest dividend payout rates and Japanese individual investors instead have tended to cash out corporate earnings as capital gains (subject to a much lower-rate of capital gain taxes, in general, 26%), this double tax has been largely illusory at least in Japan.

<sup>36</sup> Global system taxation is a method of income taxation under which all income and expenses are added up to determine the net of gross income and gross expenses, which is then taxed.

<sup>37</sup> Schedular system taxation is another method of income taxation. Under this method, the net of each type of income (*i.e.*, capital gain and salary income) and relevant costs relating thereto are taxed separately at a tax rate that is fixed for each type of income.

<sup>38</sup> Despite their similarities as global systems, unlike the United States, Japan does not give favorable treatment to capital gains for purposes of the corporate income tax.

<sup>39</sup> Neither the United States nor the Japanese system invokes the concepts of "adjusted" gross income, standard deduction or itemized deduction for corporate income tax. Therefore, corporations simply subtract all allowable deductions from gross profits or revenue to obtain taxable income under both systems.



"income."<sup>41</sup> Under the *Haig-Simons* model, "income" is the "net accretion to one's economic power between two points in time."<sup>42</sup> Phrased differently, income consists of the taxpayer's consumption for a period of time, plus the "change in the value of the store of the [taxpayer's] property rights between the beginning and end of the period in question."<sup>43</sup> Thus, the determination of *Haig-Simons* income necessitates the use of a "mark-to-market" system, under which a taxpayer's income is determined by reference to changes in the market value of the taxpayer's assets and liabilities, even though the taxpayer has not disposed of these assets and liabilities or otherwise "realized" gain or loss.<sup>44</sup>

However, because of the intractable administrative problems accompanying the full taxation of economic income,<sup>45</sup> both the U.S. system and the Japanese system generally delay the recognition of income until that income has been "realized" instead of using a mark-to-market system.<sup>46</sup> Realization is defined as the occurrence of an act or event such as a sale that signifies a change in the form of assets or properties sufficient to attract taxation.<sup>47</sup> A full application of the *Haig-Simons* model would necessitate annual estimates of market values that would be extremely subjective in nature, costly, and the source of innumerable disputes between taxpayers and the tax authority.<sup>48</sup> Moreover, basing taxable income on economic gain not yet reduced to liquid wealth could impose significant hardships on taxpayers unable to pay the tax owed because of the illiquid nature of the

---

<sup>40</sup> The term "*Haig-Simons* income" was coined after the names of Robert Haig and Henry Simons, two of the more prominent proponents of designing the tax base to reflect economic income. See Robert Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX 1*, 7(1921), reprinted in *READINGS IN THE ECONOMICS OF TAXATION* (1959); HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

<sup>41</sup> As to the adoption of this definition in the U.S. corporate income tax, see MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 107 (3d ed. 1995). As for the adoption of this definition in Japanese corporate income tax, see KANEKO, *supra* note 32, at 171, 245.

<sup>42</sup> Haig, *supra* note 40, at 7.

<sup>43</sup> SIMONS, *supra* note 40, at 50.

<sup>44</sup> *Id.* at 100. See also Thomas L. Evans, *The Evolution of Federal Income Tax Accounting—A Growing Trend Towards Mark-to-Market?*, 67 *TAXES* 824, 825 (1989); Minoru Nakazato, *Sozei-hō to Kigyō Kaikei (Shō-hō, Kaikeigaku) [Tax Laws and Corporate Accountings (Commercial Code and Accountings)]*, 1432 *SHŪJI HŌMU* 26, 29 (1996).

<sup>45</sup> Haig and Simons themselves each recognized such administrative problems. See Haig, *supra* note 40, at 68-69; SIMONS, *supra* note 40, at 103.

<sup>46</sup> See GRAETZ & SCHENK, *supra* note 41, at 160-61; KANEKO, *supra* note 32, at 244-45. See also Nakazato, *supra* note 44, at 29.

<sup>47</sup> See Evans, *supra* note 44, at 825.

<sup>48</sup> *Id.*

economic gain.<sup>49</sup> Despite the principles of realization recognized in both the United States and Japan, both countries have experienced a notable trend of mark-to-market in tax accounting in recent years.<sup>50</sup>

With respect to the scope of the allowable deductions for income tax purposes, there are significant differences between the U.S. system and the Japanese system. For example, under Section 162 of the IRC, a deduction is allowed for business expenses that are the "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."<sup>51</sup> In contrast, the Japanese corporate income tax system does not require that business expenses be "ordinary" to be deductible.<sup>52</sup> Under both systems, it is unquestionable that losses arising from distressed bank loans may, to some extent, be deducted from gross income as business expenses for the purpose of determining corporate income tax.<sup>53</sup>

Both the U.S. and the Japanese systems use progressive tax rates that generally increase as corporate income rises. Currently, the U.S. corporate income tax system uses a four-tier rate structure. The stated marginal rates<sup>54</sup> of taxation for corporate income are 15%, 25%, 34%, and 35%.<sup>55</sup> Corporations with taxable incomes over \$100,000 are subject to a 5% surtax with a cap of \$11,750, and corporations with taxable incomes over \$15,000,000 are subject to an additional 3% surtax with a cap of \$100,000.<sup>56</sup> In contrast, the Japanese corporate income tax system uses a one-tier rate structure for business corporations, with the exception that a two-tier rate

---

<sup>49</sup> *Id.* See also Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 PENN. L. REV. 1111, 1168-76 (1986), for liquidity concerns regarding a mark-to-market system and proposed solutions to those concerns.

<sup>50</sup> See generally Evans, *supra* note 44; Nakazato, *supra* note 44, at 29. See also MINORU NAKAZATO, KIN'YU TORIHIKI TO KAZEI: KIN'YU KAKUMEI-KA NO SOZEI-HO [THE TAXATION OF FINANCIAL TRANSACTION: TAX LAW UNDER THE FINANCIAL REVOLUTION] 76-89 (1998).

<sup>51</sup> For more detailed discussion as to the meaning of "ordinary and necessary" under the IRC, see GRAETZ & SCHENK, *supra* note 41, at 28-29, 236-41.

<sup>52</sup> See KANEKO, *supra* note 32, at 246.

<sup>53</sup> I.R.C. § 166(a) (1994). See BORIS I. BITTKER & LAWRENCE LOKKEN, 2 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 33-1 (2d ed., 1990). See also KANEKO, *supra* note 32, at 287. Unless otherwise indicated, all citations are to the Internal Revenue Code of 1994.

<sup>54</sup> "Marginal tax rate" is the rate of tax applicable to the last dollar of taxable income of the relevant taxpayer. It should be distinguished from "average tax rate," which is applicable to taxable income as a whole.

<sup>55</sup> I.R.C. § 11(b). The top stated marginal income tax rate for corporations was raised from 34% to 35%, retroactive to January 1, 1993, by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).

<sup>56</sup> The 5% surtax and the additional 3% surtax have the effect of creating a top marginal corporate tax rate of 43%. However, since the surtaxes are capped, the marginal tax rate for corporate income goes back down to 35% once the caps have been met. The resulting corporate tax rate structure is: 15%, 25%, 34%, 35%, 40%, 43%, and 35%. CHERYL D. BLOCK, CORPORATE TAXATION: EXAMPLES & EXPLANATIONS 6 (1998).

structure is applied to business corporations with stated capital of not more than 100,000,000 yen. The top marginal rate for business corporations was reduced several times in the 1990s, from 40%, which was effective from April 1, 1989 through March 31, 1990, to 30%, which has been effective since April 1, 1999.<sup>57</sup> In response to these reductions, the effective tax rate<sup>58</sup> on corporate income, including local taxes, has been significantly reduced from 51.04% (the rate as of April 1, 1989) to 40.87% (the rate as of April 1, 1999). In contrast, in the United States the effective rate has been almost invariant, remaining at approximately 40-41% during the 1990s.<sup>59</sup>

An example helps illustrate the differences between the U.S. and Japanese tax systems in their treatment of distressed loans. Assume that both a U.S. bank and a Japanese bank have one million dollars in distressed loans that qualify for bad debt deductions under the U.S. and Japanese tax law, in the same fiscal year during the 1980s and 1990s. Also, assume that all conditions except the effective income tax rate are the same. While the U.S. bank enjoys a tax benefit resulting from such deductions in the amount of approximately \$400,000, the Japanese bank enjoys a potentially higher tax benefit in the amount of approximately \$400,000 to \$500,000.<sup>60</sup>

---

<sup>57</sup> CTA 1965, *supra* note 33, art. 66, para. 1. See YÜJI GOMI, GUIDE TO JAPANESE TAXES 1989-90 16, 173 (1989); YÜJI GOMI, GUIDE TO JAPANESE TAXES 1999-2000 18, 165 (1999).

<sup>58</sup> "Effective tax rate" is the aggregate tax rate of federal (national) and local (state and city, etc.) applicable to income earned by the relevant tax-payer, adjusted by the tax effect of the tax deductibility of certain type of income taxes.

<sup>59</sup> As of January 1, 1992, the effective tax rate on corporate income (including state corporate income tax) in the United States was 40.14%. See TAX BUREAU, THE MINISTRY OF FINANCE OF JAPAN, ZEISEI SHUYÖ SANKÖ SHIRYÖ-SHÜ [MAJOR REFERENCE MATERIALS FOR TAX SYSTEM] 82 (1992). As of January 1, 1998, this effective rate was 40.75%. See Makoto Fujishiro, *Heisei 10-nendo Kaisei ni okeru Hōjin Zeisei Kaikaku no Gaiyō* [The Outline of the Reform of Corporation Tax in the 1998 Tax Amendments], 389 FAINANSU [FINANCE] 78 (1998).

<sup>60</sup> A more precise calculation of the scale of tax incentives for the charge-off of a distressed loan would rely on the use of a bank's "real" effective tax rate (actual taxes paid/pre-tax income), which is obtained by taking into account tax effects resulting from a variety of individual tax treatments (aimed at specified policy goals), rather than the "statutory" rate. It has been pointed out that banks in the United States have been permitted to take deductions that have reduced their "real" effective tax rate significantly below the "statutory" rate. For example, it was reported that in 1988, such "real" effective tax rate on U.S. banks was 16.12% compared with 25.92% for all industries. See F. MAROVELLI & B. MOSER, EFFECTIVE TAX RATES 15 (1990). Another survey reveals that in 1992, the "real" effective tax rate of the top ten banks in the United States was 29.2%, ranging from a low of -46.7% for Citibank, due to sizable losses, to a high of 47.2% for Wells Fargo. See SCOTT & IWAHARA, *supra* note 27, at 63. It was argued that in Japan, such "real" effective tax rates had been much higher, at least up until the earlier period of the 1990s, than U.S. counterparts, but so far no detailed figures comparable with the U.S. figures seem to be available. See Iwahara & Scott IV, *supra* note 27, at 22. However, some scholars argue that as a result of the fact that entertainment and social expenses have traditionally been non-deductible for tax purposes in Japan, on average, the "real" effective tax rate for Japanese corporations might be higher than the "statutory" effective tax rate as described above. See Hiroshi Kaneko, *Hōjinzei Seido no Hāmonaizēshon* [Harmonization of the Corporate Income Tax Systems], 1000 JURISUTO [JURIST] 97, 98-101 (1992),

Therefore, at first blush it seems that Japanese banks had at least until in the middle of the 1990s, the incentive to charge off their distressed loans in a timely manner in order to enjoy slightly greater tax benefits in the form of a larger deduction. Of course, the "actual" scale of tax incentives in connection with non-performing loans cannot be ascertained until the scale and degree of differences between tax practices in the United States and Japan, including the stringency of the requirements for allowing bad debt deductions and the extent to which bad debt losses may be carried forward or back, are carefully scrutinized.

*B. Basic Treatments for Distressed Bank Loans*<sup>61</sup>

*1. Under the U.S. Tax System*

Since 1987 the U.S. tax system has allowed large<sup>62</sup> commercial banks to deduct bad debt losses only when loans were declared uncollectible under the direct specific charge-off method of Section 166(a) of the IRC.<sup>63</sup> Prior to 1987, the U.S. tax system granted commercial banks an election to deduct bad debts under either the specific charge-off method or the reserve method.<sup>64</sup> Effective December 31, 1986, the reserve method for computing and deducting distressed loans was not available to large banking institutions.<sup>65</sup> Accordingly, large commercial banks could not deduct, any reserve additions to a loan loss reserve that did not cover the principal of a specific loan.

Under the specific charge-off method, bad debt deductions are permitted (1) for debts that become wholly worthless during the taxable year in question, or (2) for debts that are only partially recoverable, subject to restrictions set forth in the Treasury Regulations.<sup>66</sup> With respect to a partially worthless debt, the amount deductible under the specific charge-off method is restricted to an amount not in excess of the part charged off within the taxable year.<sup>67</sup> The burden of proof to establish partial or total

---

reprinted in SHOTOKU KAZEI NO HÔ TO SEISAKU [LAW AND POLICY OF INCOME TAXATION] 452, 455 (1996).

<sup>61</sup> See generally Yasuhide Yoshida, *Beikoku ni okeru Furyô Saiken Zeimu no Genjô: Kin'yu Kikan no Kêsu* [Current U.S. Tax Treatments for Distressed Loans: Case Study for Financial Institutions], 463 JICPA JÂNARU [JICPA JOURNAL] 53 (1994).

<sup>62</sup> Banks with gross assets of at least 500 million dollars.

<sup>63</sup> See Yoshida, *supra* note 61.

<sup>64</sup> See RONALD W. BLASI, *THE BANKING INDUSTRY* 412 (1992).

<sup>65</sup> See *id.*

<sup>66</sup> I.R.C. § 166(a); Treas. Reg. § 1.166-3 (1998). See also BLASI, *supra* note 64, at 407.

<sup>67</sup> I.R.C. § 166(a)(2); Treas. Reg. § 1.166-3(a)(2) (1998). See also BLASI, *supra* note 64, at 407.

worthlessness for obtaining a bad debt deduction rests upon the taxpayer bank.<sup>68</sup>

Currently, commercial banks that do not fall within the definition of "large" banks are still allowed a deduction for a reasonable addition to its loan loss reserve. This deduction is taken in lieu of any bad debt deduction under the direct specific charge-off method. The amount of any deductible reserve addition is calculated under Section 585 of the IRC, using the experience approach.<sup>69</sup> Thus, under the reserve method, a commercial bank other than a "large" bank may add to its bad debt reserve the amount called for on the basis of its actual loan loss experience, as indicated by losses for the current fiscal year and the preceding five years.<sup>70</sup> The allowable reserve addition under this approach is equal to the amount needed to increase the balance of the loan loss reserve for losses on loans at the close of the taxable year to either (1) the reserve balance determined under a moving-average approach, or (2) the reserve balance determined by reference to the base year amount, whichever is greater.<sup>71</sup>

## 2. *Under the Japanese Tax System*

Japan, unlike the United States, permits all banks to use the reserve method to deduct a specified amount of bad debt expenses for corporate income tax purposes, in addition to the direct specific charge-off method.<sup>72</sup> Japanese tax law recognizes three categories of loan loss reserves: (1) a general loan loss reserve ("General Reserve"); (2) a special account for loan depreciation ("Special Depreciation Account"); and (3) a special loan loss reserve for certain types of foreign loans ("Special Foreign Reserve").<sup>73</sup>

The Special Depreciation Account<sup>74</sup> is designed to cover specified individual loans depending on their respective collectibilities. This is significantly different from the loan loss reserve in the United States. Since the Special Depreciation Account is used to cover the charge-off of only actual losses or of specific loans on which losses are highly likely, the

---

<sup>68</sup> See BLASI, *supra* note 64, at 407.

<sup>69</sup> *Id.* at 420. Thrifts (such as S&Ls) may also use, to some extent, the percentage of taxable income approach under the reserve method. *Id.*

<sup>70</sup> *Id.* at 425.

<sup>71</sup> I.R.C. §§ 585(b)(2)(A), (B). See also BLASI, *supra* note 64, 425-26.

<sup>72</sup> CTA 1965, *supra* note 33, art. 52. See also KANEKO, *supra* note 32, at 286.

<sup>73</sup> See SCOTT & IWAHARA, *supra* note 27, at 27.

<sup>74</sup> Hōjin-zei hō [Corporation Tax Act], Law No. 34 of 1965, art. 52, para. 1.1 (as amended by Law No. 24 of 1998) (Japan) [hereinafter CTA 1998]; Hōjin-zei hō sekō rei, [Corporation Tax Act Enforcement Cabinet Order] art 96, para. 1 (as amended by Cabinet Order No. 44 of 1998) (Japan) [hereinafter CTA Order].

function of such a Special Depreciation Account, if introduced in the United States, could substantially overlap with the function of the specific charge-off method.

Under the Special Foreign Reserve system, banks and thrifts<sup>75</sup> are entitled to deduct 1% of the total of the net incremental amount of qualified foreign loans and the balance of rescheduled foreign loans after the base date for corporate income tax purposes.<sup>76</sup>

Pursuant to a trend that mirrors the United States' experience, the maximum amount deductible for corporate income tax purposes under the General Reserve has consistently been reduced since the establishment of the system in 1950 by the Shoup Mission Report on Japanese Taxation.<sup>77</sup> As a result of the 1998 Amendments to the CTA, commercial banks and thrifts, other than those with stated capital of 100,000,000 yen or less,<sup>78</sup> may not use the previously permitted flat-rate (0.3%) percentage of eligible loans approach<sup>79</sup> when calculating the ceiling amount of any deductible reserve addition to their General Reserve. In using the experience approach, they will only generally be allowed to add to their General Reserve the amount required on the basis of their actual experience as indicated by losses for the previous three fiscal years. In other words, the amount of the General Reserve deductible for corporate income tax purposes will be the ratio of average actual loan losses to total loans over the previous three years.<sup>80</sup>

In addition to the three types of loan loss reserves mentioned above, Japanese banks are entitled to compute their bad debt deductions by the

---

<sup>75</sup> Thrifts are federal or state-chartered thrift institutions, which include savings banks and savings and loan associations. Most of them are regulated by the Office of Thrift Supervision, which was established as an office of the Department of the Treasury on August 9, 1989.

<sup>76</sup> *Sozei tokubetsu sochi hō* [Special Tax Treatment Law], art. 55-2 (Japan) [hereinafter STTL]. In the United States, there is a counterpart of this Special Foreign Reserve system in Japan. Under the Lending Supervision Act of 1983, the U.S. federal banking regulatory agencies require U.S. banks to establish and maintain special allowances, "Allocated Transfer Risk Reserves ("ATRR")," for country risk exposures classified by the regulatory agencies as "value impaired." Additions to these provisions are deductible for U.S. federal income tax purposes. U.S. banks have the option of deducting these losses at the time of booking those additions to these reserves or electing to recognize the deductible losses when the losses are eventually realized (e.g., on asset sale). See VIVIEN A. BEATTIE ET AL., *BANKS AND BAD DEBTS: ACCOUNTING FOR LOAN LOSSES IN INTERNATIONAL BANKING* app. A, 145, 149 (1995).

<sup>77</sup> See Toshio Nishino, *Furyō Saiken no Shōkyaku to Hikiatekin, Saiken Shōkyaku Tokubetsu Kanjō* [*Charge-off of Distressed Loans, as well as Bad Debt Reserve and Special Depreciation Accounts*], 28 *KOKUSHIKAN HOGAKU* 149, 163 (1996).

<sup>78</sup> Those "small" banks and thrifts may elect to use the percentage of eligible loans approach whereby they may deduct reserve additions under the General Reserve system up to 0.3% of their total loans instead of calculating deductible reserve additions to the General Reserve by using the experience approach. But if they elect to use this approach, they may not deduct any reserve additions under the Special Depreciation Account system. See STTL, *supra* note 76, arts. 57-59.

<sup>79</sup> See CTA 1998, *supra* note 74, art. 52 para. 1.2; CTA Order, *supra* note 74, art. 96, para. 2.

<sup>80</sup> *Id.*

direct specific charge-off method under Article 22, Paragraph 3 of the CTA.<sup>81</sup> Under the specific charge-off method, bad debt deductions are permitted for debts that become wholly worthless during the taxable year, subject to their actual charge-off during such taxable year.<sup>82</sup> Unlike the United States, since 1980 the Japanese tax authority has taken the position that partially worthless debt does *not* entitle a bank to bad debt deductions under the specific charge-off method, even if the worthless portion is charged off within the relevant taxable year.<sup>83</sup> According to a recent judgment of the Supreme Court of Japan,<sup>84</sup> the burden of proof to establish total worthlessness of a loan for the purpose of obtaining a bad debt deduction rests upon the taxpayer bank.

### III. MAJOR DIFFERENCES BETWEEN THE U.S. AND JAPANESE TAX SYSTEMS

#### A. *Timing of Deductions for Tax Purposes*

##### 1. *The Different Implications of the "Conformity Rule" Between the United States and Japan*

###### a. *Under the U.S. tax system*

The United States provides banks with two conclusive presumptions of worthlessness when the banks wish to recognize bad debt deductions under the direct specific charge-off method.<sup>85</sup> The first is a presumption allowed under Treasury Regulations since 1936, and the second is the "conformity election," a presumption incorporated in the Treasury Regulations in 1991.<sup>86</sup> If either of these presumptions applies, debts will be

---

<sup>81</sup> See KANEKO, *supra* note 32, at 287.

<sup>82</sup> See Kokuzeichō hōjin-zei kihon tsūtsu [Tax Agency Basic Circulars on CTA] 9-6-2 (Japan) [hereinafter Circular 9-6-2].

<sup>83</sup> See Kokuzeichō hōjin-zei kihon tsūtsu [Tax Agency Basic Circulars on CTA] 9-6-4 (as amended by Tax Agency Circular, Choku-hō 2-15, Dec. 25, 1980) (Japan) [hereinafter Circular 9-6-4]; Kokuzeichō hōjin-zei kihon tsūtsu [Tax Agency Basic Circulars on CTA], Nin'tei ni yoru saiken shōkyaku tokubetsu kanjō ni kansuru unyō-jō no Ryūiten ni suite [Notes Concerning Administration of Special Depreciation Account], Ka-hō 2-4, Sa-chō 4-4, Sept. 18, 1992 (Japan) [hereinafter Special Depreciation Account]. Both Circulars were repealed by Kokuzeichō tsūtsu [Tax Agency Circulars], Ka-hō 2-7 of 1998, as a result of the 1998 Amendments to the CTA.

<sup>84</sup> *Case reprinted in* 28 [11] ZEIMU JIREI 65 (Sendai High Ct. Apr. 12, 1996), *aff'd*, 29(4) ZEIMU JIREI 16 (Sup. Ct. Nov. 22, 1996).

<sup>85</sup> See BLASI, *supra* note 64, 407-08.

<sup>86</sup> See Yuri Okina, *Nichibei Hikaku kara Mita Kin'yū Kikan no Kasidaore Hikiatekin no Atsukai* [Comparative Study on Treatments for Bad Debt Reserve of Financial Institution in the U.S. and Japan], JAPAN RES. REV., Oct. 1992, at 24, 28.

conclusively presumed worthless and thus deductible for tax purposes in the year in which they become worthless.

Under the 1936 presumption set forth in Section 1.166-2(d)(1) of the Treasury Regulations, a bank loan is presumed worthless when ordered charged off by a bank regulator and if charged off in accordance with established regulatory policy and confirmed as such in writing in the next subsequent audit by the bank regulators.<sup>87</sup> Under the conformity election, a debt that is charged off, in whole or in part, will be presumed to have become worthless in the taxable year of the charge-off.<sup>88</sup> A debt is considered charged off if it is pursuant to a specific order of the bank's federal supervisory authority, or if the debt is classified by the bank as a "loss asset" under applicable bank regulatory standards.<sup>89</sup> A "loss asset" is a debt assigned to a class under standards set forth in the "Uniform Agreement on the Classification of Assets and Securities Held by Banks" or similar guidance issued by the relevant bank regulator. Relevant bank regulators include the Office of Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corp. ("FDIC"), Federal Reserve Board ("FRB"), Farm Credit Administration ("FCA"), and the Office of Thrift Supervision ("OTS").<sup>90</sup> Under FDIC Guidelines, examiners may order loans charged off when a qualifying event occurs, such as foreclosure or the filing of bankruptcy causing the realization of the loss to be certain.<sup>91</sup> Low-value, high-volume loans (consumer installment loans, credit card loans, and check credit plans) are subject to regulated charge-off procedures.<sup>92</sup> For example, consumer installment paper that is delinquent 120 days or more and credit card and check credit debt more than 180 days late are considered "loss assets" for regulatory purposes.<sup>93</sup>

In short, in the United States, banks enjoy bad debt deductions for their distressed loans for tax purposes when those loans are judged as "loss assets" by regulatory bodies. Some argue that because regulatory bodies tend to regard distressed loans as "loss assets" more often than the tax authority, bad debt deductions are more frequently taken by commercial banks and thrifts.<sup>94</sup>

---

<sup>87</sup> SCOTT & IWAHARA, *supra* note 27, at 29.

<sup>88</sup> Treas. Reg. § 1.166-2(d)(3) (1993).

<sup>89</sup> See BLASI, *supra* note 64, at 408.

<sup>90</sup> Treas. Reg. § 1.166-2(d)(4)(ii)(C) (1993). See BLASI, *supra* note 64, at 410.

<sup>91</sup> Iwahara & Scott III, *supra* note 27, at 17 n.43.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> See Okina, *supra* note 86, at 29.



b. *Under the Japanese tax system*

From 1950 through 1997, Japan adopted a "conformity" rule for bad debt deductions for tax purposes.<sup>95</sup> Under this rule, which was known as the "Charge-off Certification System for Distressed Loans," a bank's loss or reserve addition to the Special Depreciation Account was automatically deducted for corporate income tax purposes<sup>96</sup> if a bank examiner at the Ministry of Finance ("MOF") issued a certification that a loss had occurred, or that the requirements for the Special Depreciation Account were met with respect to certain loan principal held by a bank. Although this rule was established by the Tax Agency Circular<sup>97</sup> and the MOF Banking Bureau Release,<sup>98</sup> the tax authority treated it as a prerequisite for the bad debt deduction, except that a loss was also incurred by the relinquishment of relevant loan principal based on a plan approved by a bankruptcy court or rearrangement among the creditors.<sup>99</sup> In this sense, the rule was treated by the tax authority as a "compulsory" conformity rule for bad debt deductions.

Many commentators argue that the Japanese version of the conformity rule has contributed to the curbing and delaying of bad debt deductions for tax purposes.<sup>100</sup> Until 1998, both the bank regulator and the tax authority in Japan had been organizational components of the MOF, resulting in a conflict of interest.<sup>101</sup> This was quite different from the United States, where the bank regulatory bodies are separate agencies independent from the tax authority (the Internal Revenue Service ("IRS")) and are not subject to any "supervision" by the IRS or its supervisory agency, the U.S. Department of Treasury.<sup>102</sup> Furthermore, until June 1998 the Japanese bank regulatory body, the Financial Supervisory Agency ("FSA"), was independent from the MOF, and financial and tax considerations had almost always driven bank regulatory policy because of the dominance of the Financial Bureau and Tax

<sup>95</sup> See, e.g., *id.* at 26.

<sup>96</sup> YŌICHI TAKAHASHI, SHINPAN: KESU SUTADĪ NI YORU KIN'YŪ KIKAN NO SAIKEN SHŌKYAKU [NEW EDITION: EXPLANATIONS BASED UPON CASE STUDIES: CHARGE-OFFS BY A FINANCIAL INSTITUTION OF ITS DISTRESSED LOANS] 10 (2d ed. 1994).

<sup>97</sup> Kokuzeichō hōjin-zei kihon tsūtsū [Tax Agency Basic Circulars on CTA], Kin'yū kikan no kasitsukekin no shōkyaku ni tsuite [Charge-off of Loan Principal Held by Financial Institution], CHOKU-HŌ 1-42, Jun. 14, 1950 (repealed July 1997).

<sup>98</sup> Furyō saiken no shōkyaku ni tsuite [Charge-off of Distressed Loan], GIN-GIN No. 310, May 10, 1950 (repealed in July 1997).

<sup>99</sup> See TAKAHASHI, *supra* note 96, at 38.

<sup>100</sup> See HORIUCHI, *supra* note 6, at 171; SCOTT & IWAHARA, *supra* note 27, at 28; Okina, *supra* note 86, at 26-27.

<sup>101</sup> See Okina, *supra* note 86, at 27, 29.

<sup>102</sup> See *id.* at 26-29.

Bureau over the Banking Bureau in the power-politics within the MOF.<sup>103</sup> As a result, maximizing the collection of taxes frequently prevailed over the administrative need to secure the sound operation of banks, thereby reducing the likelihood of approved bad debt deductions in Japan.<sup>104</sup>

This reluctance by Japan to allow the prompt charge-off of distressed bank loans was amplified by the MOF's fear of triggering a financial panic by disclosing the true financial conditions of troubled financial institutions to the public.<sup>105</sup> For example, after a MOF special investigation revealed that seven *jusen* companies<sup>106</sup> were saddled with approximately 4648 billion yen of nonperforming loans and other bad debts, several major banks requested that the MOF allow charge-offs of loans to these companies. The MOF denied the request.<sup>107</sup> In addition, the MOF and tax authority refused to allow bad debt deductions for the Industrial Bank of Japan and the Long-Term Credit Bank of Japan with respect to their fiscal year ending on March 31, 1996 after the banks relinquished their distressed loans against their affiliated *jusen* companies. The MOF stated that such deductions would not be allowed until a special statute for the dissolution of *jusen* companies was enacted and the dissolution agreements were executed in writing.<sup>108</sup> In November 1995, almost half of the gross assets of the seven *jusen* companies,<sup>109</sup> equaling 6410 billion yen in total, had already been officially classified as "loss assets" by the MOF's special inspections. The fact that the MOF and tax authority nevertheless refused bad debt deductions for the above loans against those "living-dead" companies clearly betrayed the strong and extraordinarily stringent position adopted by the Japanese tax authority toward the bad debt deduction.

In conclusion, although Japan had maintained a conformity rule similar to the set of presumption rules adopted by the United States, until

<sup>103</sup> See, e.g., HORIUCHI, *supra* note 6, at 171; SCOTT & IWAHARA, *supra* note 27, at 28.

<sup>104</sup> *Id.*

<sup>105</sup> See HORIUCHI, *supra* note 6, at 140-41; Kanaya & Woo, *supra* note 11, at 26.

<sup>106</sup> "*Jusen* companies" are seven housing loan companies in Japan established principally by banks and other financial institutions after the 1970s under the supervision of the MOF.

<sup>107</sup> See Ginkō Nayamasu "Jikosatei," ["Self-Assessment" Annoys Banks], NIHON KEIZAI SHINBUN, morning edition, Aug. 20, 1997, at 7.

<sup>108</sup> See Shōsuke Takeda, *Botai-kō no Kaijo Jōken-tsuki Saiken Hōki to Kasidaore Sonshitsu ni Kansuru Saiketsu ni tsuite: Kokuzei Fufuku Shinpansho Hei 9.10.27. Saiketsu no Kentō* [Decision Dealing With the Issues of Revocable Relinquishment by the Controlling Bank of its Loan Principals to the Controlled *Jusen* Housing Loan Company and Resulting Bad Debt Losses: Review of the Decision of The National Tax Tribunal, dated Oct. 27, 1998], 1510 KIN'YŌ HŌMU JUYŌ 25 (Oct. 27, 1998).

<sup>109</sup> At the end of March 1995, the aggregate amount of seven *jusen* companies' gross assets hit 13,060.4 billion yen. See THE MINISTRY OF FINANCE & THE MINISTRY OF AGRICULTURE, FORESTRY AND FISHERIES, JUSEN-TŌ KANKEI SIRYŌ [REFERENCE MATERIALS BOUND REGARDING JUSEN HOUSING LOAN COMPANIES, ETC.] 41 (1996).

July 1997,<sup>110</sup> the practical effect on the timing of bad debt deductions was opposite to that of the U.S. rules. The likely cause of these differences was the Japanese governmental structure, in which both the bank regulator and the tax authority were supervised by the MOF, in contrast to the decentralized governmental structure of the United States. In retrospect, it is quite obvious that the Japanese version of the conformity rule never offered any tax incentives to facilitate charge-offs by banks of their distressed loans.

## 2. *General Loan Loss Reserve*

### a. *Under the U.S. tax system*

As mentioned above, the United States repealed the general loan loss reserve ("reserves for bad debts") system under which both "large" banks and "non-large" banks could deduct certain amounts of reserve additions irrespective of the occurrence and amount of actual loan losses. This repeal was driven by the U.S. Congress' desire to move the entire income tax system closer to a model measuring income based on the *Haig-Simons* income model, through a mark-to-market system. Professor Thomas L. Evans explained the background of this repeal as follows:

Under this reserve method, changes in the reserve balances generally were accompanied by corresponding changes in taxable income. An increase in a reserve balance would be accompanied by an increase in bad debt expense, while a decrease in a reserve balance would be accompanied by a decrease in bad debt expense. Arguably, a reserve method, which reflects declines in the value of a group of assets (receivables, loans, etc.), more closely approximates a mark-to-market system in that declines in the value of these assets are reflected currently, with a corresponding increase in expense to reflect the diminution in the taxpayer's wealth that has occurred. Thus, under such a view, the repeal of the reserve method under the 1986 Act was a step away from mark-to-market that was undertaken for nothing more than revenue reasons. However, in the view of the Treasury economists involved in the initial tax reform proposals that advocated the repeal of the reserve method, the actual use of the reserve

---

<sup>110</sup> See *supra* notes 97 and 98 and accompanying text.

method violated mark-to-market principles by prematurely reflecting losses that had not yet occurred, and by accounting for assets (net of reserves) at values that were less than their true market value. A simple example will explain this theory.

Assume that a commercial bank makes 1000 consumer loans of \$1000 each on December 31, 1989, each bearing a market rate of interest. Also assume that, the bank, based on past experience, reasonably believes that it will fail to collect 5 percent, or \$50,000, of the total loan balance, although of course the bank does not know which particular loans will prove to be uncollectible. On the bank's balance sheet, for its taxable year ending December 31, 1989, the \$1,000,000 cash expenditure by the bank would be reflected by an increase in its loans receivable of \$1,000,000, simply reflecting the fact that the bank had converted some of its cash into a different type of asset, i.e., loans receivable. However, under the reserve method, the reserve representing estimated uncollectible loans would also be increased by \$50,000 to reflect the bank's estimate of uncollectible amounts with respect to the new loans. Similarly, with other factors being held constant, bad debt expense would be increased by \$50,000 to reflect this increase in the reserve account. This simple example illustrates the fallacies of the reserve method and the rationale for its ultimate repeal. Under the reserve method, the portfolio of loans made on December 31, 1989 for an aggregate amount of \$1,000,000 is valued at only \$950,000, and the corresponding decline in the carrying value of the loans is accounted for as an expense. However, it is unreasonable to assume that the fair market value of the loan portfolio is less than \$1,000,000 on December 31, 1989, because a taxpayer should not be presumed to purchase an asset (the loan portfolio) for \$1,000,000 if on the date of purchase the portfolio is worth \$950,000. The presumption instead should be that the loan portfolio would be worth its purchase price of \$1,000,000. Thus, the reserve method has contravened a mark-to-market system by valuing assets at less than their value, with a corresponding decrease in taxable income accompanying the undervaluation. Assuming, in the above example, that \$50,000 of the \$1,000,000 loaned will never be collected, one might then inquire as to how the loan

portfolio is worth \$1,000,000, as opposed to \$950,000. The response is, of course, that sufficient interest is charged by the bank to compensate the bank for the loss of the \$50,000 principal with respect to the bad loans. That is, interest that is charged and collected on the loans that are paid by the debtors will compensate the bank for the principal (and interest) that the bank will suffer with respect to the loans that are never collected. Moreover, banks anticipate that they will suffer some loan losses from debtor defaults; the interest rate charged by banks on loans is designed to take these losses into account and provide the bank's owners with a return on their investment commensurate with the risk that they are taking by investing money in the bank. Under this theory, the economic income of the bank is more accurately determined by allowing the bank a deduction for loan losses only when specific loans become worthless, in whole or in part, in future periods. During these future periods, the bank will also recognize interest income on its loans that prove to be "good loans," with the risk premium implicit in this interest income offsetting the deduction for worthless loans that is taken in the same period. Thus, under this analysis, Congress moved closer to a mark-to-market system by repealing the reserve method, in that the reserve method understated the assets of a taxpayer, while overstating its expenses, by prematurely recognizing a decline in value that was economically attributable to a future occurrence. By allowing only the charge-off method to be used in determining such losses, the tax base more accurately reflects the economic situation of the taxpayer by valuing assets in a manner that more closely approximates their market value.<sup>111</sup>

Thus, from the viewpoint of income taxation, the repeal of the reserve method and adoption of the charge-off method would arguably provide a more accurate account of a taxpayer's economic situation.

*b. Under the Japanese tax system*

Unlike the U.S. tax system, the Japanese tax system still maintains the General Reserve system for all banks, even after the 1998 Amendments to

---

<sup>111</sup> Evans, *supra* note 44, at 840-41 (footnotes omitted).

the CTA. Commentators have frequently argued that compared to the United States, Japanese banks enjoy favorable tax treatment in connection with their distressed loans. They contend this is because of the 1986 U.S. repeal of reserve method accounting for bad debt deductions.<sup>112</sup> Certainly, Japanese banks have *historically* enjoyed significant tax benefits under the General Reserve system. Until 1971, the maximum amount of the general reserve under the tax law was 1.5% of the aggregate amount of loan assets, while the average of the Japanese banks' ratios of net loan loss against their total loan assets from 1956 through 1992 was only 0.06%. Against these government to bank "hidden subsidies," there was strong criticism from consumer groups and some politicians that the above General Reserve rate was higher than the real loan loss rate, and that the General Reserve was being used to hide excessive profitability in the banking business.<sup>113</sup> This matter was especially sensitive in 1970, given the combination of low regulated deposit interest rates and the high inflation rate resulting from the oil crisis. Since the cost of deposit interest for banking business and the rate of lending interests (which is bank income) is determined basically by the inflation rate, bank profits (derived mostly from the spread between the lending interest and the deposit interest) constantly increased during this period. As a result, from 1971 to 1982 the MOF reduced the limitation on reserve addition deductions for tax purposes under the General Reserve system for banks from 1.5% to 0.3%.<sup>114</sup>

It should be noted that the MOF Banking Bureau adopted the same limit for bank regulatory purposes, even though it regulates bank capital to protect the safety and soundness of banks, and does not collect taxes.<sup>115</sup> This is additional evidence that tax considerations drove regulatory policy in Japan until the FSA became independent from the MOF in 1998.

From 1982 to 1998, the 0.3% limitation on reserve addition deductions for tax purposes was maintained. Specifically, the General Reserve could not exceed the *higher* of 0.3% of total loans or the ratio of average loan losses to total loans over the previous three years.<sup>116</sup> This provided Japanese banks with some tax benefits derived from the difference between the 0.3% guaranteed deduction and the bank's actual loan loss ratio until the fiscal year end on March 31, 1992. Despite this, these tax benefits have been almost completely eliminated since 1993 because the Japanese

---

<sup>112</sup> See Nishino, *supra* note 77, at 163; SCOTT & IWAHARA, *supra* note 27, at 30-31.

<sup>113</sup> SCOTT & IWAHARA, *supra* note 27, at 28.

<sup>114</sup> See *id.*

<sup>115</sup> *Id.*

<sup>116</sup> See SCOTT & IWAHARA, *supra* note 27, at 58 n.34.

banks' average ratio of net charge-offs<sup>117</sup> to total loans has constantly exceeded 0.3% since then.

The average ratio of net charge-offs to total Japanese bank<sup>118</sup> loans was 0.006% from 1956-1992.<sup>119</sup> As indicated in Table 1, the ratio of net charge-offs to the total bank loans of Japanese city banks has steadily increased with the downturn of the Japanese economy and exceeded the 0.3% threshold in the 1993 fiscal year.

**Table 1. Ratio of Net Charge-Offs to Total Bank Loans**<sup>120</sup>

Year	1991	1992	1993	1994	1995	1996	1997	1998
Ratio: net charge-offs to total bank loans(%)	0.17	0.32	0.34	0.56	1.23	0.46	1.80	1.52

The 0.3% guaranteed deduction was repealed by the 1998 Amendments to the CTA. Thereafter, deductible additions to the General Reserve could not exceed the ratio of average loan losses to total loans in a three-year period. Accordingly, Japanese banks may theoretically enjoy the tax benefits that the adoption of the reserve method itself produces by prematurely recognizing a decline of the value of their loan assets attributable to a future occurrence.<sup>121</sup>

It is uncertain, however, whether Japanese banks are actually earning any "real" tax benefits under the system. It has repeatedly been pointed out that Japanese banks, unlike U.S. banks, have long failed to procure sufficient lending margins containing adequate risk premiums designed to compensate them for bad debt losses because they have relied too much on the value of the collateral securing loans.<sup>122</sup> One piece of evidence supporting this hypothesis is the extremely low average yields on working assets of Japanese banks as compared to those of banks in other industrialized countries. In the 1990s, the average yields on working assets of Japanese

<sup>117</sup> "Net charge-offs" are defined in this context to include both the amount of charge-offs under the direct charge-off method and the amount of additions to the Special Depreciation Account.

<sup>118</sup> This includes city banks, regional banks, long-term credit banks, trust banks, and second-tier regional banks.

<sup>119</sup> SCOTT & IWAHARA, *supra* note 27, at 30.

<sup>120</sup> The source of the data is Kin'yū Zaisei Jijyō, The Bank of Japan.

<sup>121</sup> See NAKAZATO, *supra* note 50, at 72-76.

<sup>122</sup> See, e.g., *Ōte-gin, Rizaya 0.1-0.8% Kakudai: Kigyō to Kōshō e, Shinyō-ryoku ni Ōji Kinri-sa* [Money-center banks raises their lending spread by 0.1-0.8%: They are negotiating with borrowers in order to diversify their loan spreads, depending on the respective borrowers ratings], NIHON KEIZAI SHINBUN, morning edition, Mar. 21, 1999, at 1.

banks, together with their returns on assets ("ROA") and returns on equity ("ROE"), were among the lowest among industrialized countries.<sup>123</sup> If the above hypothesis is true, the maintenance of the reserve method might be necessary for Japanese banks, in order to measure their "economic income," or *Haig-Simons* income, more accurately for income tax purposes. As Evans stated,

if . . . a rate of interest is charged on the loans that is less than the market rate [which contains a risk premium designed to compensate the taxpayer for losses resulting from bad loans], then the interest that is subsequently earned on the loans will not be sufficient to offset the losses from loans that prove to be ultimately uncollectible. A reserve method would then more accurately measure the economic income of the taxpayer.<sup>124</sup>

From this perspective, the current General Reserve system might be justified as a temporary tax measure toward achieving the desired mark-to-market model.

*B. Partial Worthlessness of a Loan*

*1. Partial Worthlessness of a Loan and Other Issues Regarding the Timing of Deductions Under Japanese Tax Treatment*

*a. Special depreciation account and the CCPC*

Unlike the IRS, Japan's National Tax Agency ("NTA") has long taken a very rigid position with respect to the deductibility of a partially worthless loan,<sup>125</sup> creating impediments for Japanese banks to benefit from possible bad debt deductions. Unlike the U.S. authority, the NTA has historically prohibited all taxpayers from using the direct specific charge-off method with respect to their partially worthless loans.<sup>126</sup> Under Japanese tax practices, in order to recognize loan loss expenses for tax purposes with respect to their partially worthless loans, taxpayers must use the Special Depreciation Account system. This involves the recognition of loan loss expenses in the amount of the worthless portion of a debt by crediting the

---

<sup>123</sup> See Appendix 1; see also Kanaya & Woo, *supra* note 11, at 23.

<sup>124</sup> Evans, *supra* note 44, at 841.

<sup>125</sup> See, e.g., Kanaya & Woo, *supra* note 11, at 11.

<sup>126</sup> See Circular 9-6-2, *supra* note 82.



amount to the Special Depreciation Account. Until 1992, Japanese taxpayers were not allowed any bad debt deduction unless they could prove that more than 50% of the loan in question was unrecoverable, even if there was no possibility of collecting a lesser portion of the loan.<sup>127</sup> In addition, in order for partially worthless loans to qualify for tax deductibility, the NTA required that the bank debtors demonstrate a negative net worth for a period of at least two years.<sup>128</sup> These two requirements were great impediments for Japanese seeking to claim bad debt deductions for partially worthless loans.

In 1992, in response to the surge in the amount of distressed bank loans resulting from the collapse of the "bubble" economy, the MOF and NTA started to ease restrictions on distressed loans for financial institutions. First, they reduced the 50% floor to 40%. Second, they shortened the required period of the debtors' negative net worth from two years to one year. As a result, Japanese banks were allowed to recognize loan loss expenses with respect to a partially worthless loan when it was proved to be difficult to collect more than 40% of the entire face value of a loan, because the debtor proved to be insolvent for longer than one year, and the bank had no expectation of recovery.<sup>129</sup>

Such treatments, however, did not seem to provide adequate tax incentives for banks to timely dispose of their partially worthless loans. One reason for this was the survival of the floor requirement for tax deductibility. The U.S. tax system has never imposed such a floor requirement. As a result, Japanese banks could not realize any tax benefit from partially worthless loans if the worthless portion did not exceed such threshold (floor) percentage. In addition, it is difficult to find any justification for the floor requirement under the *Haig-Simons* income model.

Another barrier to bad debt deductions was the existence of burdensome procedural requirements imposed by the NTA in order for banks to recognize bad debt deductions. Even after the 1992 reform, banks were required to ascertain the amount of a bad debt deduction, prepare a liquidation balance sheet reflecting the market value of all assets of the relevant debtor, and to submit supporting evidence<sup>130</sup> to the NTA.<sup>131</sup>

---

<sup>127</sup> See TAKAHASHI, *supra* note 96, at 120-22.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.* See also Nin'tei-niyoru saiken shōkyaku tokubetsu kanjō ni kansuru unyō-jō no ryūiten ni tsuite [Concerning Administration of Special Account for Loan Depreciation], Tax Agency, Ka-hō 2-4, Sa-chō 4-4, Sept. 18, 1992.

<sup>130</sup> Supporting evidence may include including certified appraisal sheets from a real estate appraiser for each parcel of real estate held not only by such debtor but also by any third party account debtor.

<sup>131</sup> See Nin'tei, Jūsen wa Kanzo ni [Procedural Requirements for Certification of Charge-offs Will Be Simplified in Case of Jusen Companies], NIKKEI SHINBUN, morning edition, Feb. 21, 1996.

Clearly, the cost of preparing such materials would be disproportionate to the corresponding tax benefits with respect to certain small loans.

In an effort to circumvent these problems, in January 1993 Japanese banks set up the Cooperative Credit Purchasing Company ("CCPC") in cooperation with the MOF and NTA.<sup>132</sup> The CCPC purchases non-performing loans from banks and undertakes recovery of these loans. This achieves the same effect of bad debt deductions because the NTA permitted banks to recognize the difference between the book value and the sale price of loans they sell to the CCPC as tax-deductible expenses.<sup>133</sup> Commentators have stated that this scheme amounted to an accounting sleight of hand reminiscent of the U.S. Federal Home Loan Bank Board's management of troubled thrift institutions in the early 1980s.<sup>134</sup> The framework of this scheme is illustrated as follows:

Suppose a bank had a 100 [yen] loan to a real estate developer that CCPC determined was worth only 70 [yen]. The bank would lend CCPC 70 [yen], getting CCPC's note in return. CCPC would then use the loan proceeds to buy the loan from the bank for 70 [yen]. The bank would charge off 30 [yen], presumably reducing its capital by a like amount, and deduct the 30 [yen] loss from its taxable income. The net effect would be that CCPC rather than the developer now owed the bank 70 [yen], and the developer owed CCPC 70 [yen]. If the loan were really worth 70 [yen], the bank should have been able to sell it to a third party for that amount. In effect, the validity of the loan valuations depends on CCPC being able to sell the loans in the longer term for close to their face amounts; otherwise it will not be able to pay the banks.<sup>135</sup>

This scheme, however, also has significant problems. First, a bank must obtain an agreement from the debtor to transfer a target loan to the CCPC.<sup>136</sup> If the relevant debtor unreasonably refuses to agree to such transfer, a bank will be unable to get the bad debt deduction. Second, this

---

<sup>132</sup> See Kanaya & Woo, *supra* note 11, at 11.

<sup>133</sup> See *id.* The National Tax Agency officially confirmed such treatment. Kaitori-gaisha kōsō ni taisuru zeimu-jō no toriatsukai ni tsuite [Tax Treatments for an Idea of the CCPC], National Tax Agency, Oct. 30, 1992.

<sup>134</sup> See SCOTT & IWAHARA, *supra* note 27, at 60 n.47.

<sup>135</sup> *Id.*

<sup>136</sup> Shūji Fujimori, *Furyō Saiken Kaitori wo Meguru Mondai-ten* [Issues Concerning the Purchase of Distressed Loans], 479 JICPA JĀNARU 65-67 (1995).

scheme applies only to distressed loans secured by real estate mortgages.<sup>137</sup> Finally, this scheme has the harmful side-effect of delaying the conclusive disposition of target loans. Since the CCPC's purchase of non-performing loans is financed by corresponding loans from the selling banks to the CCPC, this scheme only succeeds in replacing the residual value of a bad loan with another non-interest bearing loan to the CCPC. Commentators correctly note that "while the CCPC provides the banks with some tax relief for their non-performing assets, it does little, if anything, to facilitate the asset recovery process."<sup>138</sup> If the value of the collateral securing the loan decreases over the period in which the CCPC holds it, "secondary" losses will occur with respect to the selling bank.

Given the above, the MOF and NTA eventually eliminated the floor requirement under the 1998 Amendments to the CTA,<sup>139</sup> allowing taxpayers to enjoy the bad debt deduction for partially worthless loans. By virtue of this amendment, all taxpayers may deduct the worthless portion of a loan (regardless of its ratio against the entire loan amount) if the debtor remains insolvent for at least one year (yielding no expectation of recovery of such portion).<sup>140</sup> However, the amendment may have come too late. Prior to the effective date of April 1, 1998, several major Japanese financial institutions went bankrupt in 1997, including Nissan Life Insurance, Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities.

*b. An introduction to the justification of NTA's policies*

To justify its stringent position with respect to the tax deductibility of a partially worthless loan, the NTA has consistently relied on Article 33, Paragraph 2 of the CTA. With respect to the recognition rules for corporate income tax of unrealized losses of certain assets, this provision provides:

Where remarkable damage due to disaster or other facts or events as prescribed by Cabinet Order has occurred to assets (*excluding deposits, savings, loans, accounts receivable and other credits*) owned by a domestic corporation, and the market value of the said assets has declined below the book value, and

---

<sup>137</sup> *Id.*

<sup>138</sup> Kanaya & Woo, *supra* note 11, at 11.

<sup>139</sup> See CTA Order, *supra* note 74, art. 96, para. 2.

<sup>140</sup> See *id.*; CENTURY AUDIT CORP., KIN'YU KIKAN NO FURYÔ SAIKEN SHÔKYAKU HIKKEI [HANDBOOK FOR CHARGE-OFF OF DISTRESSED LOANS BY FINANCIAL INSTITUTION] 126, 134-35 (3d ed. 1999). See also Circular 9-6-4, *supra* note 83; Special Depreciation Account, *supra* note 83.

the domestic corporation has reduced the book value by reckoning into expense for accounting purposes by revaluing the said assets, out of the portion thus reduced, the amount up to the balance between the book value of the said assets immediately before the revaluation and the value of the said assets at the end of the fiscal year covering the date of the revaluation shall, in spite of the preceding Paragraph, be deemed to be the deductible expense in computing the amount of taxable income in the said fiscal year.<sup>141</sup>

The NTA has interpreted the exclusion to mean that with respect to loans and other accounts, not only the recognition of an unrealized loss but also the recognition of a bad debt loss or a worthless portion thereof for corporate income tax purposes is prohibited.<sup>142</sup> Under this broad interpretation, the NTA has traditionally allowed bad debt deduction for tax purposes only when the entire amount of a loan becomes worthless when using the direct specific charge-off method.<sup>143</sup> However, the NTA has also acknowledged that a categorical disallowance of any deductions for tax purposes with respect to the worthless portion of a loan and other accounts cannot meet practical needs under actual economic circumstances.<sup>144</sup> To address this, the NTA created the Special Depreciation Account system in its rulings. Unfortunately, this was done without enacting or amending any provisions of tax statutes, and under stringent restrictions, the NTA began to allow bad debt deductions with respect to certain partially worthless loans in 1954. This system is a "compromise" with reality.<sup>145</sup>

Thereafter, the NTA gradually relaxed the requirements for the bad debt deduction with respect to partially worthless loans under the Special Depreciation Account system, but such makeshift measures eventually came to a dead end during the 1990s. This was due to a significant increase in the amount of distressed loans held by Japanese financial institutions. As a result, the MOF and NTA incorporated the Special Depreciation Account system into tax statutes and relevant regulations by way of the 1998

<sup>141</sup> CTA 1965, *supra* note 33, art. 2, para. 3 (emphasis added).

<sup>142</sup> See YOSHIO WATANABE ET AL., SHINPAN: HÖJIN-ZEI KIHON TSŪTATSU CHIKUJŌ KAISETSU [NEW EDITION: COMMENTARY ON EACH PROVISION OF BASIC CIRCULAR ON CORPORATION TAX ACT] 662 (Motoyasu Yoshikawa ed., 1999).

<sup>143</sup> See Circular 9-6-2, *supra* note 82. Exceptionally, however, if a taxpayer creditor relinquishes a portion of his loan principal, the tax authority will allow bad debt deduction with respect to such relinquished portion under the specific charge-off method so long as the debtor is insolvent at that moment. See *id.*

<sup>144</sup> See, e.g., TAKAHASHI, *supra* note 96, at 105.

<sup>145</sup> See generally Nishino, *supra* note 77, at 156-58.

Amendments.<sup>146</sup> However, most of the language of Article 33, Paragraph 2 of the CTA was kept intact.

There are five general categories of arguments justifying Article 33, Paragraph 2 of the CTA and its stringent treatment with respect to bad debt deductions for partially worthless loans.<sup>147</sup> The first category of arguments state that since any loans and accounts receivable are ultimately secured by the gross assets of the debtor, it cannot be said that any portion thereof becomes completely worthless until all of the assets of the debtor are liquidated.<sup>148</sup> This argument has been referred to as the Necessity of the Liquidation of All Assets of the Debtor Theory ("Necessity of Liquidation Theory"). The second argument is that tax accounting under the CTA must be consistent with the accounting methods of the Commercial Code, under which assets are generally booked at their acquisition costs.<sup>149</sup> The third argument is that any credits, including deposits, savings, loans and account receivables are equivalent to money and, as such, it would be improper to recognize any gains or losses before their realizations.<sup>150</sup> The fourth type of justification for this provision is that since there is no "market" for selling and purchasing loans and other accounts in Japan, it is difficult to assess their objective exchange value and it would be inappropriate to recognize any gains or losses based on such uncertain assessment.<sup>151</sup> The fifth argument emphasizes the administrative difficulty in appraising unrealized losses with respect to loans and other accounts.<sup>152</sup>

Among these arguments, the NTA seems to have principally adopted the first through third arguments as its rationale for this provision and, thus, for its stringent tax treatments of recognition of bad debt losses with respect to partially worthless loans.<sup>153</sup> In particular, the Necessity of Liquidation Theory seems to constitute the underlying theory upon which the NTA has based its interpretation of the relevant provisions of tax statutes and

<sup>146</sup> CTA 1998, *supra* note 74, art. 52, para. 1.1; CTA Order, *supra* note 74, art. 96, para. 1.

<sup>147</sup> See generally Hisaya Inouye, *Bubun Kashidaore no Ninshiki to Saiken Shōkyaku Tokubetsu Kanjō* [Recognition of Partial Worthlessness of Loan Principal and Special Depreciation Account], 31(3) ZEIRI 46, 48-49 (1988).

<sup>148</sup> See, e.g., JIRŌ YOSHIKUNI, HŌJIN-ZEI HŌ [CORPORATION TAX LAW] 467 (1965).

<sup>149</sup> See, e.g., Ichirō Hara, *Hōjin-zei Hō no Zenbun Kaisei ni tsuite* [Comprehensive Amendments of the Corporation Tax Law], 20(7) ZEIKAI TSŪSHIN 121, 152 (1965).

<sup>150</sup> See, e.g., Moriyuki Yamamoto, *Furyō Saiken no Kashidaore Sonshitsu no Zeimu to Ryūiten* [Tax Treatments and Points to Be Noted in Connection with Charge-offs of Distressed Loans], 51(2) ZEIKAI TSŪSHIN 119, 121 (1996).

<sup>151</sup> See Shōsuke Takeda, *Zeihō ni okeru Saiken no Shōkyaku: Kaishū Funō Gaku no Kettei ni tsuite* [Charge-offs of Account Receivables Under Tax Laws: Determination of the Amount of the Worthless Portion], 65(5) KAIKEI 740, at 743, 751-52 (1954).

<sup>152</sup> See Inouye, *supra* note 147, at 49.

<sup>153</sup> *Id.* at 48.

developed its tax practices with respect to the tax treatments for distressed bank loans. One good piece of evidence in support of such hypothesis is the NTA's treatment of secured bad loans. The NTA has long taken the position that *no* secured loan is allowed bad debt deduction for tax purposes under the specific charge-off method until all the relevant collateral is liquidated.<sup>154</sup> The Supreme Court has implicitly supported this tax practice.<sup>155</sup>

The NTA's practices with respect to the deductibility of a loan to a bankrupt debtor provides us with another piece of supporting evidence. The NTA has traditionally maintained the position that even if a debtor files a petition for bankruptcy and there seems to be no probability of recovery, a bad debt deduction will generally not be allowed with respect to a loan under the specific charge-off method until all assets of the debtor are liquidated and no more recovery will be made for such loan.<sup>156</sup> However, such a result imposes unreasonably harsh burdens on the creditor, especially since it may frequently take several years to complete the liquidation of a debtor's assets.<sup>157</sup> Therefore, in 1954, the NTA established relief under the Special Depreciation Account system. The relief provision of this system entitled taxpayers to deduct 50% of the amount of a loan as reserve additions for tax purposes, regardless of the actual amount of its worthless portion, when a debtor has petitioned for bankruptcy, corporate reorganization, composition of creditors or other types of bankruptcy procedures.<sup>158</sup>

The problem with the NTA's reasoning is that none of the five arguments described above is valid in modern-day Japan. The Necessity of Liquidation Theory is a derivative of the realization doctrine, which supplements the *Haig-Simons* income model.<sup>159</sup> The realization requirement is justified on the grounds that periodic taxation of accrued but unrealized gains (and losses) would cause three problems that, "taken together, appear insurmountable" from the point-of-view of the tax administration agency: "(1) the administrative burden of annual reporting; (2) the difficulty and cost of determining asset values annually; and (3) the potential hardship of

---

<sup>154</sup> See Circular 9-6-2, *supra* note 82.

<sup>155</sup> Case reprinted in 198 ZEIMU SOSHŌ SIRYŌ 1213 (Nagoya High Ct. Sept. 30, 1993), *aff'd*, 206 ZEIMU SOSHŌ SIRYŌ 57 (Sup. Ct. Oct. 25, 1994).

<sup>156</sup> See Ichirō Hara, *Kashidaore Sonshitsu [Bad Debt Loss]*, 42 JOURNAL OF JAPAN TAX RES. INST. 215, 226-27 (1999).

<sup>157</sup> In case of a bankruptcy proceeding, it is pointed out that sometimes it takes more than ten years to complete the liquidation of a debtor's assets. See *In re Sueno Kōsan Co., Ltd.*, reprinted in 1040 KIN'YŌ SHŌJI HANREI 3 (Ōsaka Dist. Ct. Mar. 31, 1998).

<sup>158</sup> CTA 1998, *supra* note 74, art. 52, para. 1.1; CTA Order, *supra* note 74, art. 96, para. 1. See also Kokuzeichō hōjin-zei kihon tsūjitsu [Tax Agency Basic Circulars on CTA] 9-6-4 to 9-6-11.

<sup>159</sup> See Evans, *supra* note 44, at 825.

obtaining the funds to pay taxes on accrued but unrealized gains.”<sup>160</sup> None of these justifications is applicable to the issue of bad debt deduction under tax laws. Since the bad debt deduction is allowed only when the financial condition of the debtor becomes essentially irrecoverable, both the burden of annual reporting and the difficulty and cost of annual assessment of asset values render the deduction meaningless. Moreover, since bad debt deduction provides only a benefit to the taxpayer, the potential hardship of obtaining funds to pay taxes renders the provision inadequate. Accordingly, applying the realization doctrine to the area of bad debt deduction contradicts the premise behind the *Haig-Simons* income model. Needless to say, the Necessity of Liquidation Theory is inconsistent with a mark-to-market tax accounting system.

The remaining arguments justifying the NTA's stringent position on the deductibility of partially worthless loans also prove unpersuasive. The second argument has been obsolete since 1999. This argument states that tax accounting under the CTA must be consistent with the accounting methods of the Commercial Code under which assets are generally booked at their acquisition costs. In 1999, the Commercial Code of Japan was amended to permit the booking of marketable accounts (including commercial paper and negotiable time certificates of deposit) at their market values rather than their face values.<sup>161</sup> The third argument is also obsolete. It argues that credits are equivalent to money and, as such, it would be improper to recognize any gains or losses before their realization. But, it is impossible to assume loans and other accounts are the equivalent of money in the present high-risk economy. Finally, both the fourth and fifth arguments have become obsolete. These arguments state that no market exists for loans and other accounts in Japan to create an objective exchange value, and that it would be administratively difficult to appraise unrealized losses with respect to loans and other accounts. But in actuality, the late 1990s saw the emergence and development in Japan of markets for loans and other accounts.<sup>162</sup> In short, Article 33, Paragraph 2 of the CTA lost all of its rationale by the late 1990s, and maintaining the provision is inconsistent with the *Haig-Simons* income model. As compared to the U.S.

---

<sup>160</sup> U.S. TREASURY DEP'T, BLUEPRINTS FOR TAX REFORM 82-83 (1977). See also GRAETZ & SCHENK, *supra* note 41, at 160.

<sup>161</sup> See Shō hō [Commercial Code], Law No. 48 (adopted Mar. 9, 1899), art. 285-4, para. 3 (as added by Law No. 125 of 1999) (Japan) [hereinafter Commercial Code].

<sup>162</sup> See generally ŌSHIMA & NISHIMURA, *supra* note 24, at 25-27, 29-33.

tax system, Japan's tax policy provides unreasonable restrictions on bad debt deductions.<sup>163</sup>

c. *Influences and impact of the Necessity of Liquidation theory on Japanese tax treatments for distressed loans*

The Necessity of Liquidation theory exerts significant influence on almost all tax treatments for distressed loans in Japan. For example, the Japanese tax authority seems to be extremely reluctant to allow bad debt deduction for a junior secured loan until all assets of the debtor are actually liquidated, even if the market value of those assets is clearly insufficient to cover even the senior secured loans owed by such debtor.<sup>164</sup> Further, the tax authority is very reluctant to allow bad debt deduction for a non-secured loan until all assets of the debtor are actually liquidated, even if the market value of those assets is clearly insufficient to cover the secured loans owed by such debtor.<sup>165</sup> Additionally, the Japanese tax authority is reluctant to allow tax deductions for subordinated loans until all assets of the debtor are liquidated and their market value is realized, even if it is obvious that the market value of the debtor's gross assets is below the face amount of senior non-secured loans owed by the debtor.<sup>166</sup> As a result, when real estate prices were continuously falling and the market for real estate mortgages became poor in the 1990s, a Japanese bank could not recognize a bad debt deduction with respect to more than 50% of the amount of its loan principal for several years, even if the debtor had already gone bankrupt and it was obvious that the market value of the debtor's entire assets was far from sufficient to cover all of the loans held by its senior lenders.

---

<sup>163</sup> See Yoshinobu Shinagawa, *Fukumi-eki, Fukumi-zon ni Kansuru Hōjin-zei no Kadai* [Open Issues on Corporate Income Tax in Connection with Unrealized Gain and Loss], 54 ZEIKI TSUSHIN 17, 21 (1999).

<sup>164</sup> See Circular 9-6-2, *supra* note 82. See also TAKAHASHI, *supra* note 96, at 101 n.7.

<sup>165</sup> See K.K. Nihon Kōgyō Ginkō v. Tōkyō Kokuzeikyoku-cho, 1510 KIN'YŪ HOMU JUŌ 36, 40 (Nat'l Tax Trib., Oct. 27, 1998); Sensui Hajime, *Tanpo Bukken Shobun Mae ni Bubun-teki Kasidaore ga Mitomerareta Jirei* [A Case Precedent That Approved the Tax Deductibility of Partial Worthless Loan Prior to the Liquidation of Collateral Held by the Debtor], 38(9) ZEIKI TSUSHIN 217, 222-23 (1983).

<sup>166</sup> See K.K. Nihon Kōgyō Ginkō, *supra* note 165, at 40. See also Takeda, *supra* note 108, at 30-34.



## 2. *Partial Worthlessness of a Loan and Other Issues Regarding the Timing of Deductions Under U.S. Tax Policy*

### a. *Tax treatments for partial worthlessness of a loan in the United States*

Unlike the tax treatments in Japan that existed up until 1998, U.S. tax law permits a deduction for partially worthless debts. This deduction is permitted on the condition that the taxpayer charges off an appropriate amount and the IRS is satisfied that the debt is "recoverable only in part."<sup>167</sup> While a deduction for a wholly worthless loan does not require any action by the taxpayer (other than claiming the deduction on the return or in a claim for refund) and must be taken in the year in which the debt "becomes worthless," a deduction for a partially worthless loan requires an election by the taxpayer and is conditioned on a charge-off<sup>168</sup> of the uncollectible amount on the taxpayer's records.<sup>169</sup> The IRS' discretion regarding a deduction for partial worthlessness must be exercised reasonably. If a taxpayer challenges the IRS' denial of a deduction for a partially worthless loan, the taxpayer's burden of proof is heavier than in the case of a completely worthless loan, because the court looks at whether or not the IRS abused its discretion in denying the deduction rather than at whether the debt was actually partially worthless.<sup>170</sup>

If a debt is actually collected in part, the unpaid balance may be deducted for tax purposes when it becomes worthless (which may be in the year of the partial payment or later), if and to the extent that the taxpayer's basis for the debt exceeds such partial payment.<sup>171</sup> If the taxpayer accepts

---

<sup>167</sup> I.R.C. § 166(a); Treas. Reg. § 1.166-3 (1998).

<sup>168</sup> I.R.C. § 166(a)(2). The U.S. Tax Court has held, however, that the creation of a specific bad-debt reserve to cover the known amount of worthlessness of a specific loan is the equivalent of a "charge-off." *Brandtjen & Kluge, Inc. v. Comm'r*, 34 TC 416 (1960), *acq.*, 1960-2 C.B. 4.

<sup>169</sup> See Treas. Reg. § 1.166-3(a) (1998); BITTKER & LOKKEN, *supra* note 53, at 33-14. See also *Int'l Proprietaries, Inc. v. Comm'r*, 18 T.C. 133 (1952) (charge-off requirement not satisfied); *Brandtjen & Kluge, Inc. v. Comm'r*, 34 T.C. 416, 440-44 (1960), *acq.*, 1960-2 C.B. 4 (effective charge-off found). See also *Nat'l Bronx Bank of NY v. Comm'r*, 147 F.2d 651 (2d Cir. 1945) (basis of debts reduced on partial charge-off even if deduction produces no tax benefit); *Rio Grande Bldg. & Loan Ass'n v. Comm'r*, 36 T.C. 657, 664 (1961) *acq.*, 1962-1 C.B. (charge-off after close of taxable year, during period required to close books, suffices); *Findley v. Comm'r*, 25 T.C. 311, 318 (1955), *aff'd per curiam*, 236 F.2d 959 (3d Cir. 1956) (partial charge-off and deduction permitted in year partial worthlessness is discovered or in a later year when debt becomes wholly worthless).

<sup>170</sup> See BITTKER & LOKKEN, *supra* note 53, at 33-14. See also *Brimberry v. Comm'r*, 588 F.2d 975 (5th Cir. 1979) (disallowance upheld), and cases cited therein; *Austin Co. v. Comm'r*, 71 T.C. 955 (1979) (abuse of discretion found); *Prod. Steel, Inc. v. Comm'r*, 39 T.C.M. (CCH) 77, 81 (1979) (although "wise exercise of business judgment supported by all of the facts available" would establish abuse of discretion by IRS, this was not shown by facts before court).

<sup>171</sup> I.R.C. § 166(a)(2). See BITTKER & LOKKEN, *supra* note 53, at 33-11.

less than the full amount of the debt and cancels the balance, there is no remaining debt to be deducted as bad debt losses under Section 166 of the IRC. The canceled amount may only be deductible as a general loss under Section 165, which is subject to restrictions.<sup>172</sup> An exception to this principle may be made, however, if the cancellation is just a formality because the creditor's claim for the balance is clearly worthless.<sup>173</sup>

*b. The inapplicability of the Necessity of Liquidation theory under U.S. tax law and practices*

Given that the worthless portion of a loan has traditionally been entitled to the bad debt deduction without any substantial limitations, this suggests that the Necessity of Liquidation Theory is inapplicable to the United States' tax law and practices. The tax treatments applied to the loan of a bankrupt debtor provide us with some evidence of this inapplicability. Section 1.166-2(c) of the Treasury Regulations explicitly states that bankruptcy "is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt" and "[i]n bankruptcy cases a debt may become worthless *before settlement* in some instances; and in others, only when a settlement in bankruptcy has been reached."<sup>174</sup> These provisions indicate that a settlement in bankruptcy (i.e., the liquidation of all assets of the debtor and distribution of money from such liquidation) is generally not required by the U.S. tax authority as a prerequisite for a bad debt deduction. In addition, commentators have argued that "in many cases, a debt may become worthless before a bankruptcy settlement has been reached."<sup>175</sup> It is also notable that Treasury Regulations do not require legal action to be taken before a bad debt deduction is allowable, when the surrounding circumstances indicate that a debt is worthless and uncollectible

---

<sup>172</sup> See BITTKER & LOKKEN, *supra* note 53, at 33-11. See also *First Nat'l Bank of Durant v. Comm'r*, 6 B.T.A. 545 (1927) (third party posted security for part of debt owed to taxpayer, who cancelled balance as uncollectible; held, loss rather than bad debt); *Thorman v. Comm'r*, 8 T.C.M. (CCH) 653 (1949) (loss rather than bad debt where taxpayer accepted part payment in full settlement). But see Rev. Rul. 68-523, 1968-2 C.B. 82 (creditor accepted property in complete satisfaction of debtor's liability; bad debt deduction allowed if property's value is less than unpaid balance; no mention of *Thorman* case).

<sup>173</sup> See BITTKER & LOKKEN, *supra* note 53, at 33-11. See also *Brown v. Comm'r*, 10 B.T.A. 1036, 1045 (1928) (on receiving part payment, taxpayer agreed to cancel balance, which was in fact uncollectible; held, subsequent release pursuant to agreement does not bar deduction of unpaid balance as worthless debt).

<sup>174</sup> Treas. Reg. § 1.166-2(c) (1993) (emphasis added).

<sup>175</sup> LANCE W. ROOK & STANLEY I. LANGBEIN, *FEDERAL INCOME TAXATION OF BANKS AND FINANCIAL INSTITUTIONS* 6-4 (6th ed. 1999).

and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment.<sup>176</sup>

A Technical Advice Memorandum issued by the IRS in 1995 ("Memorandum")<sup>177</sup> illustrates the substantial differences between United States bad debt deduction timing policy and that of Japan. The Memorandum discusses whether the Necessity of Liquidation Theory is considered an appropriate rationale for the timing of distressed loan deductions. The Memorandum hypothetically considers the tax deductibility of a subordinate debenture issued by a subsidiary and held by a parent bank. The taxpayer bank had subordinated debentures issued by its Subsidiary, which was incorporated in Country A. The debentures were subordinate to the claims of all of the Subsidiary's general creditors. In year "X-1," the banking authority of Country A determined that the subsidiary required additional loan loss provisions in order to continue in operation. As the amount of the additional loan loss provisions mandated was in excess of the value of the subsidiary's capital funds, the taxpayer concluded that the Subsidiary should cease operations. Later that year, the taxpayer bank's board of directors passed a corporate resolution committing the bank to recognizing that, among other things, the interests of the taxpayer would best be served by the Subsidiary's fully satisfying the claims of its non-shareholder depositors and creditors, in the course of implementing a "members' voluntary winding up" for the liquidation of the Subsidiary.

The taxpayer asserted that because of the significant commonalities between the customers of the taxpayer and of the subsidiary, the taxpayer would have suffered substantial damage to its goodwill and reputation within the international banking community had the Subsidiary been permitted to fail without its creditors having been satisfied in full. The resolution authorized the taxpayer's officers, among other things, to (i) terminate the Subsidiary's business, and wind up and liquidate the Subsidiary expeditiously, (ii) accept assets of the Subsidiary in full liquidation of the taxpayer's investment in the Subsidiary, (iii) account for the assets received from the Subsidiary when received by the taxpayer at such values as may be prudent, and (vi) recognize as a loss that amount by which the assets accepted in liquidation of the investment in the Subsidiary exceeds the taxpayer's basis in the Subsidiary.

In year "X-1," the taxpayer notified the banking authority of Country A that the company intended to wind up the affairs of the subsidiary, in the

---

<sup>176</sup> Treas. Reg. § 1.166-2(b) (1993).

<sup>177</sup> Tech. Adv. Mem. 95-22-003 (Jun. 2, 1995).

process providing the support required by the subsidiary to meet its financial obligations in full. The Taxpayer then did so and actually supplied funds to repay the subsidiary's obligations to its non-shareholder creditors. Subsequently, the Taxpayer entered into a formal liquidation agreement with the subsidiary, shareholder B, and the subsidiary's liquidating trustee. The liquidation agreement provided that for the purpose of restoring the subsidiary to nominal solvency so as to permit the liquidation to proceed as a voluntary winding up, the shareholders agreed to release and discharge all of the subordinated debentures and all moneys secured thereby, and to waive all claims they had as creditors of the subsidiary (to the extent necessary to ensure that the subsidiary would be solvent and fully able to discharge its non-shareholder liabilities). The subsidiary concurrently filed documentation with banking officials asserting its solvency for purposes of pursuing a members' voluntary winding up. The documents stated that as of such moment the subsidiary's total estimated deficiency equaled the amount that would be funded through the cancellation of the subordinated debentures, the waiver of the stand-by credits, and the waiver of interest bearing loans.

Based on the above findings of fact, the Memorandum noted that the taxpayer's cancellation of the subordinated debentures did not constitute a capital contribution to the subsidiary:

The facts and circumstances surrounding the instant transaction indicate that the subordinate debentures became worthless in year [X-1]. By the terms of the debenture agreement, the debentures were subordinate to the claims of all of [the subsidiary's] general creditors. At the end of year [X-1], the Taxpayer determined that [the subsidiary] was unable to satisfy the debts owed to its non-shareholder creditors, and that the subsidiary no longer constituted a viable economic entity. The Taxpayer's decision in year [X-1], to infuse sufficient funds into the subsidiary to permit satisfaction of [the subsidiary's] nonshareholder debts and to terminate [the subsidiary's] operations is testimony to the Taxpayer's determination that as of the end of year [X-1], [the subsidiary] was not capable of paying its obligations from current or future revenues or from its available assets.

The test applicable in determining whether a debt has become worthless for purposes of Section 166 is an objective one. A

person knowledgeable of the banking industry reasonably would have concluded, as did the Taxpayer, that collection of the amounts owed by [the subsidiary] under the terms of the subordinated debentures became hopeless in year [X-1]. Accordingly, even though the taxpayer did not formally discharge the subordinated debentures off of its book until year [X-2], the subordinated debentures became worthless in year [X-1], and should be deducted under section 166 of the Code in that year.<sup>178</sup>

Under this analysis, the IRS recognized the complete worthlessness of the subordinated debentures in the same year that the banking authority of Country A recognized the insolvency of the subsidiary. In other words, the IRS did not require a "one-year waiting period." This one-year waiting period is required by the Japanese tax authority for the tax deductibility of partially worthless debt in order to recognize the tax deductibility of the "entire" amount of those subordinated debentures.<sup>179</sup> In addition, bad debt deductions were allowed for tax purposes *prior to* the year in which the parties entered into a formal liquidation agreement, and prior to the taxpayer's subsequent release and discharge of its subordinated debentures against the subsidiary. This indicates that, for the IRS, the Necessity of Liquidation theory is not influential in deciding whether a bad debt deduction should be allowed. Instead, this decision provides proof that United States tax authority recognizes the "Reasonable Business Judgment" theory, under which bad debt deduction for tax purposes may be allowed when "a person knowledgeable of the relevant industry" reasonably would conclude that collection of the amounts owed by the debtor has become hopeless.<sup>180</sup>

The case of *American Offshore, Inc. v. Comm'r*,<sup>181</sup> also offers evidence that the IRS remains unconvinced by the Necessity of Liquidation theory. In this case, the central issue was whether a subordinated note secured by second preferred fleet mortgages became completely worthless on February 28, 1983 and thus entitled the taxpayers to the bad debt deduction in 1983. The debtor in this case was engaging in the business of

---

<sup>178</sup> *Id.*

<sup>179</sup> See *supra* note 140 and accompanying text.

<sup>180</sup> For an example of a case that clearly adopted this standard, see *Riss v. Comm'r*, 478 F.2d 1160 (8th Cir. 1973); *Raffold Process Corp. v. Comm'r*, 153 F.2d 168 (1st Cir. 1946); *Deeds v. Comm'r*, 47 F.2d 695 (6th Cir. 1931).

<sup>181</sup> *American Offshore, Inc. v. Comm'r*, 97 T.C. 579 (1991).

operating workboats and offshore oil rig supply services. The taxpayer creditors held an \$11 million subordinated note issued by the debtor, which was principally secured by second preferred fleet mortgages issued on twelve vessels by the debtor. A steep decline and deterioration of the offshore service industry resulted in it appearing unlikely that even the payments to the senior creditor bank could be made as required. As of February 28, the fair market value of the twelve vessels, which were the only major assets securing the subordinated note at that time, was \$9 million. This amount was inadequate to pay the more than \$15 million owed by the debtor to the senior creditor bank and secured by the first fleet mortgage on the same twelve vessels. No payments were due as of February 28, 1983 with respect to the subordinated note; the first payment under the note was not expected until 1985 under optimum conditions.

Based on these findings of fact, the U.S. Tax Court concluded that the loan was worthless before actual liquidation of collateral:

Worthlessness is determined by objective standards. Some factors that have been considered by courts in determining worthlessness include the *subordinated status of the debt*; a decline in the debtor's business; the decline in value of the property secured by the debt; claims of prior creditors far in excess of the fair market value of all assets available for payment; the overall business climate; the debtor's earning capacity; the debtor's serious financial reverses; guarantees on the debt; events of default, whether major or minor; insolvency of the debtor; the obligor's refusal to pay; abandonment of assets or business; ill health, death, or disappearance of the principals; bankruptcy or receivership; actions of the obligee in pursuing collection, i.e., whether the obligee unreasonably failed to take collection action and then claimed the deduction; subsequent dealings between the obligee and obligor; and lack of assets. No single factor is conclusive as there are no absolutes in this area. Default is a factor considered in deciding whether an obligation is worthless. The first payment under the note was not expected until 1985 under optimum conditions. No payments were due as of February 28, 1983. However, the fact that a debt had not matured does not prevent a finding of worthlessness. Similarly, the fact that a bad debt is not due at the time of deduction does not of itself prevent its allowance under Section 166. Sec. 1.166-1(c), Income Tax Regs. A

taxpayer need not wait for a default before taking a bad debt deduction if the debt is clearly worthless before any payments are due. Applying these factors to this case we conclude that as of February 28, 1983, there were reasonable grounds for abandoning any hope of repayment of the \$11 million subordinated note. We also conclude that the collapse of the offshore oil rig supply industry leading to the loss in value of the vessels is a sufficiently identifiable set of circumstances to explain the worthlessness of the subordinated note.<sup>182</sup>

As the court held that bad debt deduction is allowed *before* the actual liquidation of the collateral, this case indicates that the Necessity of Liquidation theory has not been adopted by the United States. Further, this case is clear evidence that the "subordinated status of the debt" is, under U.S. tax policy, a factor used to determine "worthlessness" in connection with a bad debt deduction.<sup>183</sup> This treatment is diametrically opposed to Japan's tax policy, which rarely allows deductions for subordinated debt until all assets of the debtor are liquidated. This is true even if it is clear that the market value of the debtor's gross assets is far below the aggregate amount of face values of senior loans owed by the debtor.<sup>184</sup>

In essence, the United States employs the "Reasonable Business Judgment" rule instead of the "Necessity of Liquidation" theory in determining whether or not a certain distressed loan has become worthless. As a result, in the United States, a holder of a distressed loan seems entitled to claim the bad debt deduction earlier than in Japan.

### C. Adoption of the "Deferred Tax Assets" Concept in Accounting

There are significant timing differences between U.S. and Japanese accounting and taxation treatments of expenses, including bad debt expenses.<sup>185</sup> These differences are quite apparent in those countries where

---

<sup>182</sup> *Id.* at 594-96 (emphasis added, citations omitted).

<sup>183</sup> The factors tending to refute the presumption that a debt is worthless include: the creditor's failure to press for payment (especially if the debtor is a relative or friend), willingness to make further advances, availability of collateral or guarantees by third parties, the debtor's earning capacity, minor defaults, payment of interest, and sluggish business conditions. See *Riss*, 478 F.2d at 1160 (further advances); *Comm'r v. Transport Mfg. & Equip. Co.*, 478 F.2d 731 (8th Cir. 1973) (debtor remained going concern); *BRH Builders, Inc. v. U.S.*, 620 F. Supp. 7 (C.D. Ill. 1985) (continued pursuit of claim and later settlement); *Record Wide Distribs., Inc. v. Comm'r*, 41 T.C.M. (CCH) 704 (1981), *aff'd*, 682 F.2d 204 (8th Cir. 1982) (taxpayer continued to do business on cash basis with debtor).

<sup>184</sup> See *supra* Part III.B.1.c.

<sup>185</sup> See BEATTIE ET AL., *supra* note 76, at 30.

the "conformity rule" has *not* been adopted in determining the tax deductibility of bad debt losses, as was the case in Japan after 1997.<sup>186</sup> This fact, however, does not seem to be clear at first in those countries where the "conformity rule" is used in determining the tax deductibility of bad debt losses, as is the case in the United States currently<sup>187</sup> and in Japan before 1997.

The common characteristic of all timing differences is that the period in which a transaction is recognized for accounting purposes differs from the recognition period for tax purposes. Under the "conformity rule," when the bank regulator acknowledges that a debt should be classified as a "loss asset," the amount of the debt is allowed as a deduction. However, the "conformity rule," which has been adopted in the United States and was recognized in Japan until 1997, covers only a debt that is classified as a "loss," and not those classified as "substandard" or "doubtful."<sup>188</sup> In both the United States and Japan, banks have been required by bank regulators to establish a loan loss provision covering at least a portion of such loan for accounting purposes, but the amount covered by such provision is not automatically recognized as "bad debt loss," even under the "conformity rule." Thus, timing differences between accounting for bad debt expenses and bad debt expense deductions have occurred, even under the conformity rule. This timing difference works in the opposite direction when the debt is actually charged off or otherwise deducted for tax purposes.

In order to eliminate or otherwise minimize the impact of these timing differences on reported cash flow, earnings, and capital for accounting purposes, a deferred tax asset or liability has historically been recognized in an enterprise's financial statements under U.S. generally accepted accounting principles ("U.S. GAAP").<sup>189</sup> These rules of recognition of a deferred tax asset (or liability) affect the impact of the loan loss provisions on earnings and capital of banks and thrifts.<sup>190</sup> Suppose, for example, that a bank made a general loan loss provision of  $l_1$  at the end of its first fiscal year. Suppose further that a general loan loss provision will be used in the next fiscal year to charge-off bad loans against which no specific loan loss provision has been made, and that a new general loss provision,  $l_2$ , will be established. Under the tax regime in which corporate income tax is charged

---

<sup>186</sup> See *supra* Part III.A.1.b.

<sup>187</sup> See *supra* Part III.A.1.a.

<sup>188</sup> See *supra* Part III.A.1.

<sup>189</sup> Under Opinion No. 11 of the Accounting Principles Board, which was published in December 1967, deferred tax assets (and liabilities) are recognized for accounting purposes.

<sup>190</sup> See BEATTIE ET AL., *supra* note 76, at 31.



at a rate  $t$  and general provisions are not deductible in determining taxable profits, the effect of the general provision on reported earnings for the *first* fiscal year, and on capital at the end of the same year, depends on how deferred tax is accounted for. In other words:

- (1) if the accounting rules do not provide for the recognition of deferred tax assets, reported earnings and capital will be reduced by  $I_t$ ; and
- (2) if the accounting rules provide for the recognition of deferred tax assets calculated using the "comprehensive" allocation method,<sup>191</sup> in which the full value of the provision is used in determining the size of the deferred tax asset, reported earnings and capital will be reduced by  $I_t (1 - t)$ .<sup>192</sup>

As a result of the fact that a deferred tax asset is recognized in the balance sheet, earnings and capital are reduced only by the *post-tax* cost of the provision, whereas if a deferred tax asset is not recognized in the balance sheet, earnings and capital are reduced by the *full* cost of the provision.<sup>193</sup> The United States has not recognized tax deductions for specific or general loan loss provisions since 1986.<sup>194</sup> Thus, U.S. banks have been cushioned against the full impact of loan loss provisions on their earnings and capital.

Realization of a deferred tax asset depends on the reversal of the loss provision and the ability to reduce the tax by the amount of the deferred tax asset, or obtain a refund. This depends on either the existence of taxable income in the year of reversal or the taxpayer's capacity to utilize all deductible losses against taxable income in fiscal years prior to the reversal.<sup>195</sup> In the United States, strict assurance that a deferred tax asset will be realized is not required to recognize such asset. Instead, a valuation adjustment must be made if it is "more likely than not" that future tax

---

<sup>191</sup> The other possible method is the "partial" provision method, which only allows for the recognition of the element of a provision that, when it reverses, will not be replaced by a new provision. See BEATTIE ET AL., *supra* note 76, at 30. Both the U.S. and Japanese rules for the recognition of deferred tax assets adopt the "comprehensive" provision method. See Masao Yanaga, *Zei Kōka Kaikei no Riron-teki Haikei to Mondai-ten* [Theoretical Backgrounds and Problems of the Accounting Method Acknowledging Deferred Tax Assets], 1522 SHŌJI HŌMU 14, 16 (1999). SATOSHI DAIGO ET AL., KOKUSAI KAIKEI KUUN TO NIHON NO KIGYŌ KAIKEI [INTERNATIONAL ACCOUNTING STANDARDS AND CORPORATE ACCOUNTINGS IN JAPAN] 52 (Satoshi Daigo ed., 1999).

<sup>192</sup> See BEATTIE ET AL., *supra* note 76, at 31.

<sup>193</sup> See *id.*

<sup>194</sup> See *supra* Part III.A.2.a.

<sup>195</sup> See *id.*

benefits will be lost, i.e., some portion or all of the deferred tax asset will not be realized.<sup>196</sup>

There are basically two methods of measuring the amount of a deferred tax asset or liability: the "deferral" method and the "liability" method.<sup>197</sup> These two methods differ principally in the effective tax rate used to measure a deferred tax asset or liability. The deferral method uses the effective tax rate in force when the timing difference originates, whereas the liability method uses the effective tax rate expected when the timing difference reverses.<sup>198</sup> Prior to 1987, the U.S. GAAP used the deferral method. In 1987, the Financial Accounting Standards Board switched to the liability method by issuing Statement of Financial Accounting Standards No. 96, entitled "*Accounting for Income Taxes*" ("SFAS 96"), which was effective for fiscal years beginning after December 15, 1988.<sup>199</sup>

In contrast to the United States, the generally accepted accounting principles in Japan ("Japanese GAAP") did not recognize a deferred tax asset or liability until 1999, except in relation to consolidated financial statements.<sup>200</sup> Under the new ordinances of the MOF and the Ministry of Justice, Japanese companies may recognize deferred tax assets in their unconsolidated financial statements for fiscal years ending on or after January 1, 1999 and they must recognize deferred tax assets and liabilities for fiscal years beginning on or after April 1, 1999.<sup>201</sup>

Many commentators have argued that this non-recognition of deferred tax assets in unconsolidated financial statements under the Japanese GAAP likely affected the choice of timing by Japanese banks for setting up the

---

<sup>196</sup> See BEATTIE ET AL., *supra* note 76, at 149 app. A.

<sup>197</sup> See *id.* at 31.

<sup>198</sup> See *id.*

<sup>199</sup> SFAS 96 was superseded by SFAS 109, *Accounting for Income Taxes*, which has been effective for fiscal years beginning after December 15, 1992.

<sup>200</sup> See SATOSHI DAIGO ET AL., *supra* note 191, at 49-50. By 1997, the following countries recognized a deferred tax asset even in unconsolidated financial statements: the United States, the United Kingdom, Germany, France, Belgium, the Netherlands, Luxembourg, Spain, Denmark, Ireland, Italy, Norway, Iceland, South Africa, Mexico, Australia, New Zealand, Canada, Brazil, Chile, Colombia, Fiji, Hong Kong, Kenya, South Korea, Malaysia, Nigeria, Pakistan, Peru, the Philippines, Singapore, Taiwan, Venezuela, Zimbabwe, Thailand, Sri Lanka, Bermuda, Bahamas, Barbados, Jordan, Mauritius. See MASAO YANAGA & HIROSHI ASHIDA, ZEI KOKA KAIKEI [ACCOUNTING METHOD ACKNOWLEDGING DEFERRED TAX ASSETS] 211-13 (1997).

<sup>201</sup> Kabushiki kaisha no taishaku taishō-hyō, son'eki keisan-sho, eigyō hōkoku-sho oyobi fuzoku meisai-sho ni kansuru kisoku [Regulations Concerning Balance Sheet, Profit and Loss Statement, Business Report and Incidental Schedules], arts. 13-2, 19-2, 29-2, 30-2, 33-2, 43 (newly introduced by the Ordinance of the Ministry of Justice No. 53 of 1998) (Japan); Zaimu shohyō-tō no yōgo, yōshiki oyobi sakusei-hōhō ni kansuru kisoku [Regulations Concerning the Terms, Format, Method of Preparation of Financial Statements, etc.], arts. 8-11, 8-12, 16-2, 17, 31-3, 32, 48-2, 49, 51-2, 52, 54, 54-2, 95-5, 98-2 (newly introduced or amended by the Ordinance of the Ministry of Finance No. 173 of 1998) (Japan).

necessary loan loss provisions for their distressed loans in the 1990s.<sup>202</sup> The management of Japanese banks has traditionally been inclined to focus on reported earnings in their financial statements on an unconsolidated basis for two reasons. First, the bank's capacity to pay dividends has been limited by the amount of reported earning under the Commercial Code of Japan.<sup>203</sup> Second, this action is significant because it has been widely believed in Japan that a decline in reported earnings on an unconsolidated basis and suspension or decrease of dividend payments would be a signal of distress and lead to a sharp fall in bank stock prices or possibly even to a run on banks.<sup>204</sup> Furthermore, guidelines issued by the stock exchanges in Japan require any listed corporations to be taken off the exchange if they incur negative income on an unconsolidated basis for three consecutive years. Therefore, Japanese banks have had a strong motivation to omit negative income from their financial statements on an unconsolidated basis.<sup>205</sup>

The following facts demonstrate the strong influences of those two factors on a bank's decision with respect to the level of additional loan loss provisioning in a fiscal year.<sup>206</sup> In 1995, Japanese banks incurred a combined loss of five trillion yen. In 1996, they tried to avoid reporting these losses, because it would risk being de-listed the following year if losses prevented dividend payment to shareholders. Such a de-listing might lead to precipitous falls in the prices of their issuing stocks. Therefore, they reduced their provisioning from 23,342 billion yen to 11,532 billion yen in 1996 to report a small profit and to pay customary dividends.<sup>207</sup> Provisioning was raised back to 25,809 billion yen in 1997. Considering the fact that non-performing loans held by Japanese banks continued to rise throughout the late 1990s, these coordinated actions of Japanese banks are unexplainable unless we presume that the management of Japanese banks were primarily driven by the above two factors.

It is apparent that rules providing for the recognition of deferred tax assets would cushion against the full impact of loan loss provisions on reported earnings on an unconsolidated basis. The lack of such regulations in Japan provided substantial disincentives for the management of Japanese

---

<sup>202</sup> See, e.g., Okina, *supra* note 86, at 25.

<sup>203</sup> See Commercial Code, *supra* note 161, art. 290 para. 1.

<sup>204</sup> See Kanaya & Woo, *supra* note 11, at 27.

<sup>205</sup> *Id.*

<sup>206</sup> The following illustrations are based on the descriptions of facts and data introduced in Kanaya & Woo, *supra* note 11, at 27, 41.

<sup>207</sup> While the aggregate amount of dividends paid out by Japanese banks in 1995 was 710 billion yen, in 1996 and 1997, the dividends were 675 billion yen and 687 billion yen, respectively. See Kanaya & Woo, *supra* note 11, at 41.

banks to establish loan loss provisions for their distressed loans before those loans would entitle them to bad debt deductions for tax purposes.

*D. Mark-to-Market Rule for the Assessment of Financial Assets*

*1. U.S. Legislation*<sup>208</sup>

Under the U.S. tax provisions of the Omnibus Budget Reconciliation Act of 1993 ("OBRA"), a "dealer in securities" is required to recognize gain or loss on its securities for tax purposes—if not held for investment or used as a hedge—based on the market value of the "securities" on the last business day of the taxable year. Specifically, Section 475 of the IRC provides that any "dealer in securities" must recognize gain or loss on any "security" that it holds at the close of the relevant taxable year as if such security were sold by such dealer for its fair market value on the last business day of the year.<sup>209</sup> The gain or loss that a "dealer" must recognize when it marks a "security" to market is the difference between the security's adjusted basis and its fair market value on that date.<sup>210</sup> Any such gain or loss resulting from marking the "security" to the market is generally recognized as ordinary income or loss to the taxpayer.<sup>211</sup>

To qualify as a "dealer in securities," a taxpayer's activity can be either the purchasing or selling of securities from or to customers.<sup>212</sup> The term "security" is defined under the IRC to include, among other things, stocks, partnership and trust interests, notes, bonds, debentures, and *other evidences of debt*.<sup>213</sup> This definition is broad enough to encompass loans made to customers of financial institutions.<sup>214</sup> Because the term "security" is broadly defined for purposes of Section 475, most U.S. banks are regarded as "dealers in securities" and are thus subject to the above mark-to-market tax accounting rules.<sup>215</sup> Indeed, Treasury regulations clearly indicate that the phrase "regularly purchase securities from customers" applies to taxpayers

---

<sup>208</sup> For a broad discussion of U.S. legislation on mark-to-market rules for financial institutions, see Jack W. Hodges & Larry D. Cannon, *Multistate Conformity With Federal Mark-to-Market Rules for Financial Institutions*, 12 JOURNAL OF BANK TAX'N 58 (1999).

<sup>209</sup> I.R.C. § 475(a). For an analysis of Section 475 and related regulations, see Marc D. Levy, James F. Malloy & Mary B. Doyle, *Mark-to-Market Final Regs. Contain Significant Changes and Gaps Requiring Further Guidance*, 11 JOURNAL OF BANK TAX'N 14 (1997).

<sup>210</sup> See Hodges & Cannon, *supra* note 208, at 58.

<sup>211</sup> I.R.C. § 475(d)(3)(A)(i). See Hodges & Cannon, *supra* note 208, at 58.

<sup>212</sup> I.R.C. § 475(c)(1).

<sup>213</sup> I.R.C. § 475(c)(2). See Hodges & Cannon, *supra* note 208, at 59.

<sup>214</sup> Rev. Rul. 97-39, 1997-39 I.R.B. 4 (holding 2).

<sup>215</sup> See Hodges & Cannon, *supra* note 208, at 59.

who make regular loans to customers.<sup>216</sup> Accordingly, most U.S. financial institutions are subject to the above mark-to-market tax accounting rules.<sup>217</sup> It should be noted that loan documents held by a bank and policyholder, and loan documents held by an insurance company would both constitute "securities" for the purpose of Section 475, and thus loans represented or evidenced by those documents are generally subject to mark-to-market accounting for tax purposes.<sup>218</sup>

As a general rule, all securities held by a dealer in securities are subject to mark-to-market tax accounting, with some exceptions. For example, the mark-to-market rules are not applicable to securities identified as "held for investment" or debt securities identified as "not held for sale."<sup>219</sup> Thus, a security that is not held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business may be exempt from the above mark-to-market tax accounting rules.<sup>220</sup> To exempt securities under this provision, the securities must be clearly identified as exempt in the dealer's records.<sup>221</sup> To illustrate, a financial institution that originates or acquires mortgage loans in the ordinary course of its trade or business makes a timely identification if the identification is made in accordance with the institution's accounting practice by no later than thirty days after the date of origination or acquisition.<sup>222</sup>

As a result, most U.S. banks may enjoy the loss deduction for tax purposes under Section 475 with respect to losses in their trading account debt instruments without selling or otherwise disposing of those instruments. Accordingly, most U.S. banks may recognize deductible losses for tax purposes with respect to their distressed loans either under the mark-to-market accounting rules or the bad debt deduction provisions set forth in Section 166 of the IRC. In order to cope with this overlap, the IRS has issued a proposed regulation that discusses the interaction between mark-to-market and the bad debt reserve methods of tax accounting. Specifically, the proposed regulation establishes rules for computing the mark-to-market gain or loss for tax purposes on partially or wholly worthless loans, as well as

---

<sup>216</sup> Treas. Reg. § 1.475(c)-1(c)(1)(i) (1996).

<sup>217</sup> Hodges & Cannon, *supra* note 208, at 59.

<sup>218</sup> See Rev. Rul. 97-39, 1997-39 I.R.B. 4 (holding 2).

<sup>219</sup> I.R.C. § 475 (b)(1).

<sup>220</sup> Treas. Reg. § 1.475(b)-1(A) (1996).

<sup>221</sup> I.R.C. § 475 (b)(2); Treas. Reg. § 1.475(b)-2 (1996).

<sup>222</sup> Rev. Rul. 93-76, 1993-2 C.B. 235. The explanations in this paragraph are quoted from Hodges & Cannon, *supra* note 208, at 59.

providing rules for banks accounting for bad debts using the reserve method of accounting.<sup>223</sup>

The proposed regulation is applicable to any U.S. bank that marks to market a loan that (a) was charged off during the relevant fiscal year because it became partially worthless, or (b) became wholly worthless during the relevant fiscal year without regard to whether the loan was charged off.<sup>224</sup> Under the proposed regulation, any gain or loss attributable to marking a loan to market is determined by deeming the loan's adjusted basis<sup>225</sup> to be the loan's adjusted basis less the amount charged off during the current and prior fiscal years.<sup>226</sup> A loan that becomes wholly worthless is deemed to have an adjusted basis of zero. Thus, any portion of a loss attributable to the worthlessness of the whole or a part of a distressed loan continues to be accounted for under the bad debt reserve provisions, and the basis of the loan continues to be adjusted as otherwise required by the IRC.<sup>227</sup>

To the extent a loan was previously charged off, any mark-to-market gain is treated as a recovery credited to the reserve.<sup>228</sup> The proposed regulation indicates that a bank using the reserve method of accounting for bad debts must credit the reserve for any portion of mark-to-market gain that is treated as recovery of a loan previously charged to the bad debt reserve account.<sup>229</sup>

The proposed regulation provides additional rules applicable to taxpayers using the reserve method of accounting for loans. First, to determine the total loans outstanding at the close of a fiscal year, the outstanding balance on a loan marked to market is increased or decreased by mark-to-market gain or loss recognized, except that the outstanding balance of the loan may never exceed the actual balance currently due.<sup>230</sup> Second, if the addition to the bad debt reserve is calculated based on a percentage of

---

<sup>223</sup> Prop. Treas. Reg. § 1.475(a)-1(f), (g), 60 Fed. Reg. 403 (Jan. 4, 1995). See Hodges & Cannon, *supra* note 208, at 68.

<sup>224</sup> *Id.* § 1.475(a)-1(f)(1).

<sup>225</sup> The debt's adjusted basis is determined under Section 1.1011-1, which provides that "[t]he adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost or other basis prescribed in Section 1012 or other applicable provision of subtitle A of the Code . . . ." *Id.*

<sup>226</sup> *Id.* § 1.475(a)-1(f)(1).

<sup>227</sup> The illustrations in this paragraph are primarily based upon the explanations from Hodges & Cannon, *supra* note 208, at 68.

<sup>228</sup> Prop. Treas. Reg. § 1.475(a)-1(f)(2), 60 Fed. Reg. 403 (Jan. 4, 1995).

<sup>229</sup> *Id.* The illustrations in this paragraph are primarily based upon the explanations from Hodges & Cannon, *supra* note 208, at 68.

<sup>230</sup> Prop. Treas. Reg. § 1.475(a)-1(g)(1), 60 Fed. Reg. 403 (Jan. 4, 1995).

taxable income, any gain or loss attributable to marking a loan to market must be taken into account in calculating taxable income.<sup>231</sup>

The proposed regulation also provides an ordering rule for gains and losses resulting from troubled loans. Troubled loans are to be recognized first under the bad debt reserve provisions and then under the mark-to-market accounting provisions. In determining whether to mark loans to market, it has been noted that banks should consider four key variances between Sections 475 and 166: (1) valuation of loans; (2) timing of gain and loss recognition; (3) nature of gains and losses; and (4) book-tax impact.<sup>232</sup>

First, banks should consider the different factors inherent in valuing loans under Sections 475 and 166. Under Section 166(a), a bank may deduct losses only when a loan becomes partially or totally worthless.<sup>233</sup> In determining whether partial or total worthlessness has occurred, the taxpayer must determine the value of the loan by considering all factors relevant to recovery of principal.<sup>234</sup> In contrast, loans subject to mark-to-market are valued at their fair market value at the close of the relevant fiscal year. This fair market value is determined based upon more than just credit risk, which is the focus under the bad debt provisions. One of the primary factors in determining the fair market value of a loan under mark-to-market accounting is interest rate risk. Interest rate risk is generally greater in fixed rate loans than in floating rate loans. By considering the differences in valuation methods between Sections 475 and 166, a bank may discover that a loan's fair market value is likely to be less than its credit risk valuation under the bad debt provisions. By marking such a loan to market, the taxpayer could receive a loss deduction under both Section 475 and Section 166. Banks, however, must also recognize the potential risk under Section 475 for creating taxable gain where none previously existed. Not only may interest rate changes result in increased fair market value, but gains may also result from the creation and recognition of attached servicing rights as separate assets requiring a valuation in addition to the valuation of the underlying loan.<sup>235</sup>

Second, banks should consider the potential tax benefit of accelerating deductible losses by marking loans to the market. One of the key differences in accounting for loans identified as exempt from mark-to-

---

<sup>231</sup> *Id.* § 1.475(a)-1(g)(2). The illustrations in this paragraph are primarily based upon the explanations from Hodges & Cannon, *supra* note 208, at 69.

<sup>232</sup> Hodges & Cannon, *supra* note 208, at 69.

<sup>233</sup> I.R.C. § 166(a).

<sup>234</sup> Treas. Reg. § 1.166-2(a) (1993).

<sup>235</sup> The illustrations in this paragraph are primarily quoted from Hodges & Cannon, *supra* note 208, at 69-70.

market and accounting for those subject to mark-to-market is the timing of gain or loss recognition for tax purposes. When a loan is identified as exempt from mark-to-market tax accounting, gain or loss will not be recognized under Section 166 until sale or other disposition of the loan or charge-off of the loan. In contrast, the accounting for a loan subject to mark-to-market reflects changes in its fair market value. As such, taxable gain or deductible loss recognition on a loan subject to mark-to-market accounting can occur at the end of every fiscal year. By marking a loan to market, a taxpayer may recognize a loan's decrease in value at an earlier stage during the loan's life cycle. If a loan is exempt from mark-to-market, the taxpayer must wait until a later period to recognize any loss. By marking the loan to market, the taxpayer may accelerate its loss deduction with respect to the loan's decrease in value.<sup>236</sup>

Third, taxpayer banks should consider the nature of gains and losses that may be recognized under Sections 475 and 166. Specifically, the mark-to-market provisions allow a taxpayer bank to take advantage of temporary changes in valuation from year to year, whereas losses recognized under Section 166 are permanent. Both gain and loss may be recognized for tax purposes under mark-to-market tax accounting, while only deductible losses may be recognized under Section 166.<sup>237</sup>

Finally, taxpayer banks should consider the book and tax treatment under both Sections 475 and 166. A bad debt deduction under Section 166 is conditioned upon a charge-off of the loan in question recognized for book purposes as well as tax purposes. In contrast, under Section 475, corresponding book recognition is not required in order to recognize deductible loss for tax purposes.<sup>238</sup>

## 2. *Japanese Legislation*

Unlike the United States, Japan did not have any legislation corresponding to Section 475 of the IRC until 2000.<sup>239</sup> Therefore, throughout the 1990s, Japanese banks did not enjoy tax advantages from earlier loss recognition with respect to securities in their trading accounts under mark-to-market tax accounting rules.<sup>240</sup>

---

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

<sup>239</sup> The United States has had such legislation in place since 1993.

<sup>240</sup> SCOTT & IWAHARA, *supra* note 27, at 43.



On March 24, 2000, amendments to the CTA ("2000 Amendments") were approved in the Japanese Diet. Under these amendments, effective for fiscal years beginning on or after April 1, 2000, all Japanese corporations are subject to mark-to-market accounting with respect to their securities. This requires the corporations to recognize gain or loss on their securities for tax purposes—if held for trading or sale—based on their present market value.<sup>241</sup>

Although the basic framework of the mark-to-market accounting rules set forth in the 2000 Amendments and relevant regulations is mostly the same as that in the United States, there are some significant differences between the Japanese rules and the U.S. rules. The most important difference is the scope of "securities" that are subject to mark-to-market tax accounting. Under the 2000 Amendments and relevant regulations, Japanese banks are subject to mark-to-market tax accounting so long as they hold any "securities" (such as notes, bonds, debentures, certificate of deposits, or commercial papers, or stocks) for trading or sale, which is different than U.S. tax policy. For instance, mere evidences of debt are excluded from the definition of "securities," unless they legally represent the rights and obligations of underlying loans.<sup>242</sup> As a result, unlike U.S. banks, Japanese banks may not, in general, enjoy the loss deduction without actually selling or otherwise disposing of those loans, even if they intentionally hold them in their trading accounts or book them as "for sale." Unlike U.S. policy, no regulations or releases issued by the Japanese tax authority indicate that loan documents held by a bank, or policyholder loan documents held by an insurance company, constitute "securities" for the purpose of the mark-to-market accounting rules.<sup>243</sup> Thus, loans only evidenced by those documents are generally not subject to mark-to-market accounting for tax purposes. Accordingly, even after the enactment of the 2000 Amendments, Japanese banks are generally not entitled to recognize deductible losses under the above mark-to-market accounting rules and may recognize deductible losses with respect to their troubled loans *only* under the bad debt deduction provisions.

As a result, even today, Japanese banks may *not*, in general, accelerate the recognition of deductible loss with respect to their bad loans by marking a loan to market and thus recognizing that loan's decrease in value at an

---

<sup>241</sup> CTA 1998, *supra* note 74, art. 61-3 (newly introduced by Law No. 14 of 2000); Hōjin-zei hō sekō rei, dai 119 jō no 13 [Corporation Tax Act Enforcement Cabinet Order] art. 119-13 (newly introduced by Cabinet Order No. 145 of 2000) (Japan).

<sup>242</sup> See CTA, *supra* note 74, art. 2.22 (as amended by Law No. 14 of 2000); Hōjin-zei hō sekō rei, dai 11 jō [Corporation Tax Act Enforcement Cabinet Order] art. 11 (as amended by Cabinet Order No. 145 of 2000) (Japan); Kokuzeichō hōjin-zei kihon tsūtsu [Tax Agency Basic Circulars on CTA] 6-3-3.

<sup>243</sup> See I.R.C. § 475(e)(2); Rev. Rul. 97-39, 1997-2 C.B. 62; IRS News Release 93-78 (Sept. 2, 1993).

earlier stage during its life cycle. Therefore, the treatment in Japan before and after the 2000 Amendments and the treatment in the United States under Section 475 of the IRC differ significantly.

*E. The Inapplicability of the Rule for Delinquent Interest*<sup>244</sup>

*1. Under Japanese Tax Treatments*

Under Japanese tax treatments, interest on loan principal is generally recognized on an accrual basis unless the ability to collect that interest is regarded as very doubtful. The Japanese tax authority has taken basically the same position as the United States regarding the non-recognition of taxable income for interest to be accrued on a delinquent (or otherwise defaulted) loan or other account receivable held by a corporation other than a financial institution.

Some Japanese commentators, however, argue that the Japanese tax authority has taken a relatively generous view concerning the non-recognition of taxable income for interest exclusively for financial institutions.<sup>245</sup> The NTA has long provided taxpayer corporations with two sets of safe-harbor rules, including bright-line tests, in connection with a period of delinquency in payment of accrued interest. As a general rule, all Japanese corporations may suspend the recognition of interest to be accrued on its loan principal during the relevant fiscal year for tax purposes if any one of the following events occurs: (1) all of the interest accrued as of the date falling one year before the end of such fiscal year remains unpaid at the end of such fiscal year and virtually no interest has been paid during the latest one year period due to the insolvency or other difficulties of the relevant debtor; (2) a bankruptcy or other similar proceeding has been initiated with respect to the relevant debtor; (3) it has proven to be difficult to collect all or a substantial portion of the relevant loan principal due to the fact that the relevant debtor has remained insolvent for a certain period and has lost the expectancy for successful continuation of its business or that the relevant debtor has suffered severe damages; or (4) any payment of all or a substantial portion of the relevant loan principal is determined to be frozen for a period of two years or more by a court decision approving a

---

<sup>244</sup> For a more in depth discussion of non-recognition of the rule for delinquent interest, see *Yoshida, supra* note 61, at 55-56.

<sup>245</sup> See *Yoshida, supra* note 61, at 55; *TAKAHASHI, supra* note 96, at 14.

reorganization plan for the debtor corporation or by a resolution of the creditors' assembly.<sup>246</sup>

A special ruling under the CTA, which was issued by the NTA in September 1966<sup>247</sup> allows a creditor corporation to refrain from recognizing delinquent interest as assets in certain circumstances. It states that with respect to financial institutions, if (1) no interest had been paid during the period from the last interest due date that is prior to the date falling *six* months before the end of the fiscal year through the end of such fiscal year and (2) the relevant creditor cannot or can hardly collect any delinquent interest (i) that had already accrued as of the last interest due date which was prior to the date falling six months before the end of the relevant fiscal year and (ii) that remained unpaid and outstanding as of the end of the immediately preceding fiscal year, then the creditor corporation may refrain from recognizing all of the delinquent interest accrued during the relevant fiscal year as assets and may suspend recognition of that interest in the calculation of taxable income. Further, the special ruling also provides that even if any delinquent interest was recognized as assets as of the end of the fiscal year, the relevant creditor may deduct that accrued but delinquent interest as bad debt, so long as the creditor has failed, despite his or her reasonable efforts to demand the payments, to collect any portion thereof for at least *two* years.

Those treatments (the so-called "6-month or 2-year" rules) are, unlike the counterpart rules in the United States, applicable categorically, irrespective of (1) whether or not the principal on which such interest is accrued is secured by any security interests, (2) the extent to which such principal is secured by collateral, and (3) whether or not such principal is or is becoming completely worthless or partially worthless. Surprisingly, under Japanese tax practices, the debtor of the principal need not be insolvent for any delinquent interest to qualify for non-recognition or bad debt deduction for tax purposes. These rules are applicable to all commercial banks, thrifts, securities firms, insurance companies, and other financial institutions.

Essentially, if a financial institution has failed to collect any portion of accrued interest for *six* months, it will be allowed to exclude that accrued interest as taxable income for tax purposes. In addition, if it has failed to receive, for at least *two* years, any payment for accrued interest that had

---

<sup>246</sup> See Kokuzeichō hōjin-zei kihon tsūtatsu [Tax Agency Basic Circulars on CTA] 2-1-15.

<sup>247</sup> Kokuzeichō hōjin-zei kihon tsūtatsu [Tax Agency Basic Circulars on CTA], Kin'yū kikan no mishū risoku no toriatsukai ni suite [Tax Treatments for Accrued but Unpaid Interest Claims Held by Financial Institution], Choku-shin (hō) 72 of 1966 (amended in 1997).

already been acknowledged as assets for accounting purposes, that accrued interest may be charged off and deducted as expenses for tax purposes.

## 2. *Under U.S. Tax Treatments*<sup>248</sup>

Like Japan, the United States generally recognizes interest on loan principal on an accrual basis, unless the ability to collect that interest is regarded as very doubtful.<sup>249</sup> As mentioned before, some Japanese commentators have argued that the IRS has long adhered to a more stringent policy regarding what it considers to be an inability to collect loan interest for tax purposes than that taken by the Japanese tax authority.<sup>250</sup> Certainly, under the tax practices of the IRS, non-recognition of interest accrual for tax purposes is, generally, not automatic, either upon the borrower's default in the payment of interest or when a bank regulatory agency requires suspension of accrual.<sup>251</sup> The IRS has declared in its Coordinated Issue Papers that interest accrual must continue until (1) the bank, bank examiner or regulatory agency has given specific written instructions that the loan principal upon which the interest accrues should be charged off in whole or in part, or (2) on loans not charged off, the taxpayer substantiates that the interest is "uncollectible."<sup>252</sup> According to this guideline, the U.S. banks may not, in principle, refrain from recognizing interest income concerning their delinquent interest for tax purposes until they charge off the relevant loan principal. In addition, the IRS has stated that "it can be seen that there appears to be agreement on the basic law in the area; however, it is not believed that merely because an account becomes 30 days or more past due there is little or no likelihood of collection in the future."<sup>253</sup> Therefore, at first blush, the U.S. tax authority appears to be more reluctant than the Japanese authority to allow financial institutions to abstain from recognizing accrual of interest for income tax purposes.

<sup>248</sup> For an in-depth discussion of U.S. delinquent interest, see BLASI, *supra* note 64, at 319-322.

<sup>249</sup> See I.R.C. § 446; Treas. Reg. § 1.446-1(c)(1)(ii) (2001).

<sup>250</sup> See Yoshida, *supra* note 61, at 55; TAKAHASHI, *supra* note 96, at 14.

<sup>251</sup> Treas. Reg. § 1.446-1(c)(2)(ii) (2001); Rev. Rul. 80-361, 1980-2 C.B. 164.

<sup>252</sup> See I.R.S., *ISP Paper Explains Interest Accrual on Delinquent Loans*, TAX NOTES TODAY, June 8, 1992, available at LEXIS, Taxation Library [hereinafter *ISP Paper*]. See also *id.* at ¶102.05 (discussion of the Claim of Right Doctrine); Tech. Adv. Mem. 83-17-004 (May 19, 1981) (containing approval by the IRS of discontinuance of accrual when the taxpayer, on a loan-by-loan basis, determined that interest was uncollectible. Some commentators pointed out that under the tax practices of IRS, if a loan is substantially charged off, accrual on the entire loan may be discontinued. See BLASI, *supra* note 64, at 319-20 n.132.

<sup>253</sup> See *ISP Paper*, *supra* note 252.

However, with respect to this standard, the IRS has issued Revenue Ruling 81-18,<sup>254</sup> which specifically discussed the issue of whether a taxpayer thrift may refrain from recognizing the accrual of interest. In this Ruling, the taxpayer thrift charge-off interest accrued on the books and in default for ninety days pursuant to regulations of the Federal Home Loan Bank Board ("FHLBB")<sup>255</sup> and the charge-off was confirmed in writing by the FHLBB examiners upon the first audit of the thrift following the charge-off.<sup>256</sup> The taxpayer did not offer any evidence to show that the interest was not collectible, nor did it charge off any of the principal. Based upon this finding of fact, the IRS concluded that the charge-off, as confirmed by the bank examiners, was conclusive evidence that the interest due and payable was not collectible, and thus the non-recognition by the taxpayer of future accruals of interest was automatically justified.<sup>257</sup> This conclusion was obviously based on the applicability of Treas. Reg. § 1.166-2(d), which provides a conclusive presumption of worthlessness if (1) a loan is charged off in compliance with the specific orders of a bank regulator, or (2) a loan is charged off and the charge-off is confirmed in writing by the appropriate bank regulator upon its examination of the bank following the charge-off.<sup>258</sup> Subsequently this Ruling was confirmed in IRS Technical Advice Memorandum 82-51-001,<sup>259</sup> a private letter ruling involving two savings and loan institutions. In this ruling, the IRS expressly stated that it is unnecessary for the taxpayer to charge-off the underlying debt, provided that the requirements of Treas. Reg. Sec. 1.166-2(d) are met.<sup>260</sup> If there is no charge-off of the accrued and taxed delinquent interest, a loan-by-loan analysis will normally be required under the U.S. tax treatments, because the conclusive presumption of Treas. Reg. Sec. 1.166-2(d) is unavailable.<sup>261</sup> Recognition of interest income must be reinstated if the debtor's circumstances change such that the ability to collect is assured.<sup>262</sup>

---

<sup>254</sup> Rev. Rul. 81-18, 1981-1 C.B. 295.

<sup>255</sup> 12 C.F.R. § 563c.11(b)(1) (1987) provides that interest shall be classified "uncollectible" if any portion thereof is due but uncollected for a period in excess of 90 days, with certain exceptions. This provision then provides that "[a]t least quarterly, appropriate income accounts shall be charged with the amount of uncollectible income and a corresponding amount shall be credited to an account or accounts descriptive of uncollectible income." See BLASI, *supra* note 64, at 320 n.134.

<sup>256</sup> It is understood that the Office of the Comptroller of the Currency does not issue confirmation letters. However, state banks receive such letters from Federal Reserve Board bank examiners.

<sup>257</sup> See BLASI, *supra* note 64, at 320.

<sup>258</sup> See *id.*

<sup>259</sup> Tech. Adv. Mem. 82-51-001 (Dec. 15, 1981)

<sup>260</sup> See BLASI, *supra* note 64, at 320.

<sup>261</sup> Tech. Adv. Mem. 81-37-004 (May 19, 1981). See BLASI, *supra* note 64, at 321.

<sup>262</sup> Clifton Mfg. Co. v. Comm'r, 137 F.2d 290 (4th Cir. 1943). *Clifton* arose on appeal from the Tax Court, which discussed but did not decide the issue. Subsequently, in *New Hampshire Fire Ins. Co. v.*

The threshold set forth in Revenue Ruling 81-18 has generally been considered to be applicable to commercial banks as well, since there does not appear to be any rational justification for a distinction in the treatment of thrifts and commercial banks.<sup>263</sup>

The standard of proof for the non-recognition of interest accrual for tax purposes differs from the test for charging off a bad debt<sup>264</sup> to obtain the bad debt deduction. In *Corn Exchange Bank v. U.S.*,<sup>265</sup> the Second Circuit stated that "[i]t is not necessary that there be equally as strong evidence [to discontinue interest accrued] as warrants charging off an account as a loss, as in the case of a bad debt."<sup>266</sup> The Board of Tax Appeals earlier held that a reasonable doubt as to the ability of the debtor to pay justified reporting to the tax authority only the amount of interest that was actually received.<sup>267</sup>

If interest is accrued as taxable income (and recognized as assets for accounting purposes) and subsequently becomes uncollectible, the bank may be entitled to take a loan loss deduction.<sup>268</sup> There is no specific safe harbor rule with any bright-line period of no payment with respect to when that accrued interest is deemed to be "uncollectible" for tax purposes. It is considered to be improper to reverse the accrual by reducing interest income.<sup>269</sup> Thus, if during the taxable year a loan is determined to be "uncollectible," accrual of interest is first recognized for tax purposes up to the date on which such uncollectibility is determined.<sup>270</sup> Thereafter, a loan loss deduction will be allowed for the accrued but "uncollectible" interest.

### 3. Analysis

Although there is no bright-line safe harbor rule for the non-recognition of delinquent interest as taxable income in the United States, the conclusion that U.S. tax treatments are *always* more stringent than those of

---

Comm'r, 2 T.C. 708 (1943), *aff'd*, 146 F.2d 697 (1st Cir. 1945), the Tax Court indicated its approval of the Court of Appeals decision.

<sup>263</sup> See, e.g., BLASI, *supra* note 64, at 319-20.

<sup>264</sup> *Id.* at 319-21.

<sup>265</sup> *Corn Exchange Bank v. U.S.*, 37 F.2d 34, (2d Cir. 1930). This holding was confirmed by Johnson v. Comm'r, T.C. Memo. 1982-517, 44 T.C.M. (CCH) 1076, 1083 (1982).

<sup>266</sup> *Corn Exchange Bank*, 37 F.2d at 35.

<sup>267</sup> *Atlantic Coast Line R.R. Co. v. Comm'r*, 31 B.T.A. 730, 749 (B.T.A. 1934), *aff'd*, 81 F.2d 309 (C.C.A. 1936). See BLASI, *supra* note 64, at 321.

<sup>268</sup> See BLASI, *supra* note 64, at 321.

<sup>269</sup> *Spring City Foundry Co. v. Comm'r*, 292 U.S. 182, 185 (1934). See also *ISP Paper*, *supra* note 252 (discussion of the Claim of Right Doctrine).

<sup>270</sup> Rev. Rul. 80-361, 1980-2 C.B. 164; Rev. Rul. 81-18, 1981-1 C.B. 295. See BLASI, *supra* note 64, at 321.

Japan in this particular instance<sup>271</sup> does not necessarily follow. Ironically, Japanese "generous" tax treatments for accrued and delinquent interest might decrease possible tax incentives for Japanese banks to dispose of their distressed loans on a timely basis. Under those rules, Japanese banks are not required to charge off their relevant non-performing loan principal in order to avoid income taxation on their accrued and delinquent interest, that increases continuously as time passes.

#### *F. Restructuring of Troubled Debts*

##### *1. Under U.S. Tax Treatments*<sup>272</sup>

In the United States, there is a set of sophisticated bright-line rules that deal with a "restructuring" or alteration of debt instruments as potential taxable events. This set of rules was incorporated into the Treasury Regulations<sup>273</sup> under Section 1001 of the IRC in 1992 and is specifically focused on the issue of whether a "restructuring" or alteration would be treated as a "realization event" that triggers tax consequences.

The genesis of this set of rules is the 1991 Supreme Court decision in *Cottage Savings Ass'n v. Comm'r*,<sup>274</sup> which held that the exchange of participation interests in home mortgage loans by two savings and loans ("S&Ls") was a "taxable exchange," even though the Federal Home Loan Bank Board ("FHLBB"), which at that time regulated S&Ls, concluded that the loans were substantially identical for accounting purposes. The issue in this case was whether a taxpayer S&L could realize tax-deductible losses when it exchanged its interests in one group of residential mortgage loans for another S&L's interests in a different group of residential mortgage loans. Under the new accounting directive issued by the FHLBB, S&Ls were able to recognize tax-deductible losses associated with mortgages that were exchanged for "substantially identical" mortgages held by other lenders, without reporting losses for accounting purposes. The FHLBB's acknowledged purpose for such regulation was to facilitate transactions that would generate tax losses but would not substantially affect the economic

---

<sup>271</sup> See Yoshida, *supra* note 61, at 55; TAKAHASHI, *supra* note 96, at 14.

<sup>272</sup> For a discussion of U.S. tax treatments for restructuring troubled debts, see generally Lorence L. Bravenec & David N. Hurtt, *Modifications of Debt Instruments as Taxable Exchanges*, 75 TAXES 369 (1997).

<sup>273</sup> Treas. Reg. § 1.1001-3 (1996).

<sup>274</sup> *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991).

position of the transacting S&Ls. The Court concluded that such a transaction did give rise to deductible losses for tax purposes.

In *Cottage Savings*, the petitioner S&L sold "90% participation interests" in 252 mortgages to four S&Ls. It simultaneously purchased "90% participation interests" in 305 mortgages held by these S&Ls.<sup>275</sup> All of the loans involved in the transaction were secured by single-family homes, most in the same geographical area. The fair market value of the package of participation interests exchanged by each side was approximately \$4.5 million. The face value of the participation interests relinquished by the petitioner S&L in the transaction was approximately \$6.9 million. The petitioner S&L claimed a tax deduction of approximately \$2.5 million, which represented the adjusted difference between the face value of the participation interests that it traded and the fair market value of the participation interests that it received. The principal issue in dispute was whether the transaction constituted a "disposition of property" under § 1001(a) of the IRC. The Commissioner argued that an exchange of property can be treated as a "disposition" under § 1001(a) only if the properties exchanged are "materially different" and that, because the underlying mortgages were essentially economic substitutes, the participation interests exchanged by the petitioner were not "materially different" from those received from the other S&Ls.

Based upon the foregoing findings, the Supreme Court held the following:

Neither the language nor the history of the Code indicates whether and to what extent property exchanged must differ to count as a "disposition of property" under § 1001(a). Nonetheless, we readily agree with the Commissioner that an exchange of property gives rise to a realization event under § 1001(a) only if the properties exchanged are "materially different."<sup>276</sup> . . . Precisely what constitutes a "material difference" for purposes of § 1001(a) of the Code is a more complicated question. The Commissioner argues that properties are "materially different" only if they differ in economic substance. To determine whether the participation

---

<sup>275</sup> By exchanging merely participation interests rather than the loans themselves, each party retained its relationship with the individual obligors. Consequently, each S&L continued to service the loans with respect to which it had transferred the participation interests and made monthly payments to the participation interest-holders.

<sup>276</sup> *Cottage Savings Ass'n*, 499 U.S. at 560.



interests exchanged in this case were “materially different” in this sense, the Commissioner argues, we should look to the attitudes of the parties, the evaluation of the interests by the secondary mortgage market, and the views of the FHLBB. We conclude that § 1001(a) embodies a much less demanding and less complex test.<sup>277</sup> . . . Under our interpretation of § 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are “materially different”—that is, so long as they embody legally distinct entitlements. [The petitioner]’s transactions at issue here easily satisfy this test. Because the participation interests exchanged [between the petitioner] and the other S&L’s derived from loans that were made to different obligors and secured by different homes, the exchanged interests did embody legally distinct entitlements. Consequently, we conclude that [the petitioner] realized its losses [for tax purposes] at the point of the exchange.<sup>278</sup>

The IRS issued the aforementioned set of regulations in response to the ambiguous holding in *Cottage Savings*. The lack of clarity of the meaning of *Cottage Savings* had been felt acutely, especially in the area of debt modifications, and some commentators expressed concerns that *Cottage Savings* might have created a “hair trigger” test for realization upon the modification of debt instruments. Thus, the IRS issued the set of regulations to define what constitutes a “significant modification” of a debt instrument such that the parties are deemed to have “exchanged” a modified instrument for the original debt.<sup>279</sup>

Under these new regulations, if the parties agree to substantially change any major terms of a debt instrument, a “taxable exchange” will be deemed to have occurred.<sup>280</sup> Major terms include (1) changing the yield by more than twenty-five basis points; (2) extending the loan term by an amount in excess of the shorter of five years or half of the original loan term; or (3) vesting in a borrower a right to accelerate the payment of the loan principal or vesting in a lender a right to prepayment.

This treatment of a “restructuring” or alteration as a taxable exchange could have significant tax consequences, both favorable and unfavorable, to

---

<sup>277</sup> *Id.* at 562.

<sup>278</sup> *Id.* at 566.

<sup>279</sup> See GRAETZ & SCHENK, *supra* note 41, at 175.

<sup>280</sup> See Treas. Reg. § 1.1001-3(e)(1) (1996).

taxpayers.<sup>281</sup> For example, if the holder's basis in the old debt instrument was less than the new instrument's fair market value, the restructuring of troubled debt could give rise to recognized loss for tax purposes to its holder at the same time that the holder would have to recognize taxable gain if a non-recognition provision were applicable.<sup>282</sup> In summary, for a "restructuring" or alteration of a debt instrument to be a "taxable exchange" under the above regulations, two conditions must be satisfied: (1) the alteration must be a "modification" and (2) this modification must be "significant."<sup>283</sup> *Appendix 2, infra*, illustrates the correlation of the rules relating to the "modification" requirement and those relating to the "significant" requirement.

Further, it should be noted that sometimes both U.S. courts and bank regulators have allowed certain U.S. financial institutions to recognize losses only for tax purposes *without* booking corresponding losses for accounting purposes in order to strengthen the financial soundness of those institutions. For instance, as mentioned in *Cottage Savings*, on June 27, 1980, the FHLBB issued a regulatory directive generally known as "Memorandum R-49," officially titled, "Reciprocal Sales of Mortgage Loans."<sup>284</sup> In the late 1970s, many S&Ls held numerous long-term, low-interest mortgages that declined in value as a result of the surge of interest rates during that period. These institutions would have benefited from selling their devalued mortgages in order to realize tax-deductible losses. They were, however, deterred from doing so by the existing FHLBB accounting regulations, which required them to record the losses on their books to recognize deductible losses for tax purposes. Reporting these losses in conformity with the then-effective FHLBB accounting regulations would have placed many S&Ls in financial difficulties, including the risk of closure by the FHLBB. In response to this situation, the FHLBB relaxed its requirements for the reporting of losses by issuing Memorandum R-49 to facilitate transactions that would generate tax losses and, thus, mitigate the financial difficulties of S&Ls resulting from such devaluations of their mortgage loans.<sup>285</sup> Under Memorandum R-49, S&Ls were exempted from reporting losses associated with mortgages that were exchanged for "substantially

---

<sup>281</sup> See Bravenec & Hurtt, *supra* note 272, at 370.

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

<sup>284</sup> Memorandum R-49 was rescinded effective as of Oct. 21, 1991, but was incorporated into the OTS' Thrift Activities Handbook Section 470 as of the same date by Regulatory Bulletin 1-1a issued by the OTS. See Office of Thrift Supervision, Recission of Memorandum and Bulletins, Reg. Bull. 1-1b, at 7 (Jan. 13, 1995), at [http://www.ots.treas.gov/bltn\\_regulatory.htm](http://www.ots.treas.gov/bltn_regulatory.htm).

<sup>285</sup> See *Cottage Savings Ass'n*, 499 U.S. at 557.

identical" mortgages held by other lenders, even when they had recognized those losses for income tax purposes. The U.S. Supreme Court, in *Cottage Savings*, officially endorsed the position that S&Ls were entitled to recognize deductible losses generated by such types of exchanges for tax purposes without reporting losses for accounting purposes.<sup>286</sup>

The U.S. system has been quite flexible in the recognition of losses for tax purposes in connection with distressed bank loans. If there is some legitimate business necessity and reasonable justification for recognizing losses for tax purposes from the viewpoint of the *Haig-Simons* income doctrine, the U.S. system in many instances has not hesitated to allow financial institutions to recognize deductible losses only for tax purposes without reporting losses for accounting purposes. It has not always clung to the formalistic "principle" that to be recognized as deductible losses for tax purposes, those losses should first be recognized and reported as losses for accounting purposes.

## 2. *Under Japanese Tax Treatments*

Under Japanese tax law and practice, even if the material terms of a debt instrument are changed or modified, its holder has traditionally not been allowed to recognize any loss or gain for tax purposes *as a result of* such change or modification. This applies to an instrument that does not fall within the category of a "security" and that is not sold, relinquished or otherwise disposed. Japanese tax authorities are, however, able to recognize taxable gains or to refuse to recognize deductible losses for such holder or its counter-party, if any material terms of the debt instrument are changed or modified. For example, if a creditor reduces the interest rate of a loan to a debtor without any justifiable reason, the tax authority may ignore such reduction of the interest rate and recognize the accrual of taxable income at the original interest rate for such creditor.<sup>287</sup>

In Japan, the taxpayer holder of a debt instrument may in certain cases disregard a change to the material terms and, thus, defy the challenge by the

---

<sup>286</sup> Note that Justice Blackman stated as follows in his dissenting opinion in *Cottage Savings*:

I find it somewhat surprising that an agency not responsible for tax matters would presume to dictate what is or is not a deductible loss for federal income tax purposes. I had thought that that was something within the exclusive province of the Internal Revenue Service, subject to administrative and judicial review.

*Id.* at 569 (Blackmun, J., dissenting).

<sup>287</sup> CTA 1998, *supra* note 74, arts. 22 para. 2, 37 para. 7. See KANEKO, *supra* note 32, at 245-46, 279-81.

tax authority to recognize taxable income or to disallow deductions for tax purposes. For example, if a Japanese bank reduces the interest rate of a loan to a certain debtor, the bank may not recognize any loss for tax purposes corresponding to the decrease in the fair market value of the principal of such loan. However, the bank will be allowed, under certain limited circumstances, to exclude as taxable income an amount of interest equal to the difference between the arm's-length interest rate and such reduced interest rate. In addition, unlike the United States, Japan has no set of sophisticated bright-line rules that deal with a "restructuring" or alteration of debt instruments in terms of income tax treatments. The rules applicable to the "restructuring" of debt instruments are fragmented and disorganized. There are only several isolated guidelines dealing with the reduction of an interest rate to be accrued on loan principal or with the extension of the maturity of a loan, in addition to a set of guidelines dealing with the release of a debt obligation.

The following is an outline of the major relevant guidelines issued by the NTA in connection with the "restructuring" of troubled loans:

- (1) When a corporation relinquishes the whole or part of its loan principal on a loan to its subsidiary or other debtor, the corporation is allowed to recognize a deductible loss corresponding to the amount of the loan so relinquished, so long as such relinquishment is executed for the purpose of avoiding a larger loss to be incurred in the future or for some other compelling reason.<sup>288</sup>
- (2) When a corporation relinquishes the whole or a portion of its loan principal on a loan to its subsidiary or other debtor, the corporation is allowed to recognize a deductible loss corresponding to the amount of the loan so relinquished, so long as such reduction or release is executed to prevent the troubled debtor from going bankrupt and is based upon a reasonable rehabilitation plan or otherwise based upon any reasonable justification.<sup>289</sup>
- (3) When a corporation reduces or waives an interest rate to be accrued upon its loan principal on a loan to its subsidiary or other debtor, the corporation is allowed to not recognize taxable income corresponding to the amount of interest equal to the difference between the arm's-length interest rate and the reduced or released interest rate. This is permitted so long as the reduction or release is executed to prevent

---

<sup>288</sup> Kokuzeichō hōjin-zei kihon tsūtatsu [Tax Agency Basic Circulars on CTA] 9-4-1.

<sup>289</sup> Kokuzeichō hōjin-zei kihon tsūtatsu [Tax Agency Basic Circulars on CTA] 9-6-1(1).

the troubled debtor from going bankrupt and is based upon a reasonable rehabilitation plan or otherwise based upon any reasonable justification.<sup>290</sup>

- (4) When the loan term is extended or an installment payment plan is introduced for the repayment of loan principal based upon a decision of either a competent bankruptcy court, a reasonable resolution at a creditors' meeting or a reasonable agreement entered into by and among creditors through mediation by a neutral third party, a taxpayer creditor may establish a loan loss provision and deduct for tax purposes the amount of loan principal as is determined to be necessary to be repaid more than five years after the close of the fiscal year in which the above decision is made.<sup>291</sup> Further, as to the extension of interest due dates, the aforementioned "six months" threshold and "two years" threshold for financial institutions<sup>292</sup> are also applicable. (In essence, these provide that if a financial institution has failed to collect any portion of accrued interest for six months, it will be allowed to not recognize that accrued interest as taxable income, and if it has failed to receive for at least two years any payment of accrued interest, such accrued interest may be charged off and deducted as an expense for tax purposes.)

In addition to the foregoing, unlike the United States, Japan had a significant tax impediment to the bulk sale of distressed loans until late 1998. Until December 4, 1998, there was no pertinent authority (including any guidelines or rulings of the tax authority) allowing taxpayers to estimate, for tax purposes, the fair market value of a mortgage loan based upon the expected cash flows to be earned from the relevant mortgage in the future. Also lacking were explicit guidelines on estimating the fair market value of distressed (mortgage) loans.<sup>293</sup> As a result, whenever a Japanese taxpayer wished to sell his or her distressed loans in bulk, the taxpayer would be subject to the substantial risk that the tax authority might challenge the "fairness" of the sale price of such bulk loans, finding that the fair market value of those loans should be higher than the actual price. Such a risk could result in the tax authority disapproving the recognition of certain capital losses generated by the bulk sale and could require recognition of the corresponding amount of taxable "donation income" to the purchaser of

---

<sup>290</sup> Kokuzeichō hōjin-zei kihon tsūtatsu [Tax Agency Basic Circulars on CTA] 9-4-2.

<sup>291</sup> CTA 1988, *supra* note 74, art. 52, para 1.1; CTA Order, *supra* note 74, art. 96, para. 1.1.

<sup>292</sup> See *supra* Part III.E.1.

<sup>293</sup> See ŌSHIMA & NISHIMURA, *supra* note 24, at 95-96.

those loans.<sup>294</sup> This risk was largely eliminated as of December 4, 1998, by the issuance of a new NTA tax guideline.<sup>295</sup> In estimating the fair market value of loans or underlying real estate mortgages, this guideline allows taxpayers to rely on an appraisal conducted in accordance with a reasonable method acknowledged by the Japanese Institute of Certified Public Accountants or the Japanese Association of Real Estate Appraisal. One such reasonable method is the capitalization of expected earnings method.

Unlike the U.S. system, the Japanese system has been extremely stringent with respect to recognizing deductible "losses" in connection with distressed bank loans purely for tax purposes. Under Japanese tax treatments, unless a special statute allowing it exists, no "loss" will be recognized for tax purposes without first being recognized and reported as a loss for accounting purposes.<sup>296</sup> Moreover, there exists no counterpart or other treatments similar to Memorandum R-49. In essence, Japan has never had a comprehensive and coherent framework for providing tax incentives to facilitate the restructuring of troubled loans and expedite the disposition of non-performing loans held by financial institutions.

#### *G. NOL Carryback for Commercial Banks and Tax Treatments Specifically Focusing on Banks*

##### *1. U.S. Legislation*

##### *a. The original enactment of the ten-year NOL carryback for commercial banks*

Prior to the Tax Reform Act of 1969, there was no special net operating loss ("NOL") carryback provision for commercial banks under the

---

<sup>294</sup> It has been pointed out that, ordinarily, the purchase price in this kind of bulk sale is, both in the United States and in Japan, agreed by and between the parties, based upon such estimation of the future returns from the underlying mortgages, to be approximately 10% of the aggregate face value of the distressed loans to be transferred. *See id.* at 93, 97-98, 120. Therefore, the impact of the tax risk of the disallowance of recognition of deductible capital losses was prohibitive for this kind of transaction. In order to eliminate this substantial tax risk, a bill (Fudōsan ni kansuru kenri tō no chōsei ni kansuru rinji sochi hōan [the Bill of Temporary Measurement Act Concerning the Coordination of the Rights and Other Interests in Connection with Real Estates]), which was designed to provide for the elimination of such risk for the sale of loans or other assets in certain cases was submitted to the Diet in October 1998. It was not, however, passed by the Diet. *See id.* at 19, 106-07.

<sup>295</sup> *See* Kokuzeichō hōrei kaishaku tsūtatsu [Statutes and Regulations Interpretation Circular], Tekisei hyōka tetsuzuki ni motozuite santei sareru saiken oyobi furyō saiken tanpo fudōsan no kagaku no zeimu-jō no toriatsukai ni tsuite [Tax Treatments for the Market Value of Loans or Real Estate Collaterals Securing Distressed Loans Estimated Through the Due Appraisal Process], KA-HO 2-14, SA-CHO 4-20, Dec. 4, 1998.

<sup>296</sup> CTA 1998, *supra* note 74, art. 22, para. 4.

IRC. Under the 1954 IRC, which was in effect until the enactment of the 1969 Tax Reform Act, a commercial bank's NOL was treated like that of any other taxpayer. As such, an NOL for a commercial bank could be used as a carryback for each of the three taxable years preceding the taxable year of the loss.<sup>297</sup> Therefore, a commercial bank was, like other companies, entitled to claim a refund to recover the income tax already paid for any of such three years under such treatment.

The Tax Reform Act of 1969 extended this ordinary carryback period for commercial banks. It extended the period from three to ten years by providing that "in the case of a financial institution [such as a commercial bank] . . . a[n] NOL for any taxable year beginning after December 31, 1975, shall be a[n] NOL carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be a[n] NOL carryover [i.e., carryforward] to each of the 5 taxable years following the taxable year of such loss."<sup>298</sup>

According to the Ways and Means Committee Report issued by the House of Representatives, this ten-year carryback provision was designed to provide commercial banks with an extra margin of safety in the event that an unusually devastating bad-debt loss might occur.<sup>299</sup> Generally, with regard to bad-debt losses, the bad-debt reserves for commercial banks that still existed at that time were supposed to be adequate to cover losses and to protect the banks.<sup>300</sup> Congress decided, however, that in order "to provide an extra margin of safety to protect against the possibility of unusually large bad debt losses, banks will be permitted to carry back net operating losses for ten years instead of two years as under present law . . . In addition, commercial banks will be permitted, as under present law, to carry forward net operating losses for five years."<sup>301</sup> Thus, the ten-year carryback provision was enacted for the purpose of protecting the banking industry from the adverse economic consequences of severe bad-debt losses.

Leaders in the banking industry have since provided other explanations as to why Congress originally chose to enact the ten-year NOL carryback provision. According to Mr. W. Dean Cannon, the president of the California League of Savings Institutions, ". . . [when] Congress granted savings institutions the authority to carry net operating losses back 10 years to recover taxes already paid . . . Congress explicitly acknowledged that

---

<sup>297</sup> See I.R.C. § 172(b)(1)(A) (1954).

<sup>298</sup> I.R.C. § 172(b)(1)(F) (1969) (emphasis added).

<sup>299</sup> H.R. REP. NO. 91-413, at 121 (1969).

<sup>300</sup> See *id.*

<sup>301</sup> *Id.*

accepting short-term deposits to fund long-term mortgage loans made thrifts vulnerable to losses when interest rates rise rapidly.”<sup>302</sup> Moreover, “the housing depression of 1981-82 proved the wisdom of this measure . . . [When] (f)orced to pay high market rates for deposits, while carrying old, low-interest loans on the books, the industry as a whole experienced losses totaling nearly \$9 billion.”<sup>303</sup> While these losses were undoubtedly devastating, they were not as bad as they might have been had the ten-year NOL carryback provision not been in place. According to a letter that Representative Glenn Anderson of California received from W. Dean Cannon, “. . . [I]f the ten-year carryback provision of the 1969 law had not been available to restore much-needed capital, far fewer institutions would have survived.”<sup>304</sup>

While the banking industry may have felt that the ten-year carryback provision helped to provide capital in terms of high market interest rates, Congress made it quite clear that the provision was intended to provide relief from bad-debt losses. In other words, although the ten-year carryback provision may have benefited the banking industry in other ways, it was originally enacted in order to protect commercial banks from suffering unusually large NOLs resulting from bad-debt losses that could not be adequately protected by normal bad-debt reserves.

*b. Amendment to the ten-year NOL carryback*

The Tax Reform Act of 1969 introduced the extended ten-year carryback provision for financial institutions. However, the implementation of Tax Reform Act of 1986 expressly limited the provision.

Before 1986, a commercial bank could apply an NOL carryback to the prior ten taxable years so long as the NOL occurred in 1976 or later. With the Tax Reform Act of 1986, however, Congress severely limited the ten-year carryback “window” period for commercial banks. In the House of Representatives’ Ways and Means Committee Report issued prior to the Tax Reform Act, the Committee looked at the discrepancy between the treatment of commercial banks and other types of entities. It noted that while “commercial banks . . . may carry net operating losses (NOLs) back to the prior ten taxable years and forward to the succeeding five taxable years,” taxpayers that did not qualify as commercial banks or financial institutions

---

<sup>302</sup> 131 CONG. REC. E4100 (daily ed. Sept. 18, 1985) (statement of Rep. Anderson).

<sup>303</sup> *Id.*

<sup>304</sup> *Id.*



could only "carry net operating losses back to the prior three taxable years and forward to the succeeding fifteen years."<sup>305</sup>

After examining the difference between carryback provisions for financial institutions and the treatment of other taxpayers, the Ways and Means Committee concluded that "net operating losses incurred by financial institutions such as commercial banks and thrift institutions should be treated in the same manner as [ ] other taxpayers."<sup>306</sup> Apparently, the Committee believed "that an election should be available to commercial banks to treat all of their net operating losses in the same manner as the net operating losses of other taxpayers."<sup>307</sup>

Unfortunately, no further explanation is offered as to how or why the Committee reached this conclusion. Moreover, there was not any testimony that would shed light upon the Committee's ultimate decision to repeal the carryback provision for commercial banks. However, one article suggests that Congress realized that the large NOLs incurred by thrifts in the early 1980's was essentially a thing of the past when it repealed the 1969 carryback provision.<sup>308</sup> This hints at the possibility that Congress repealed the special carryback provision because it was aware that an era of bad-debt NOLs was coming to an end, and thus the special ten-year carryback provision was no longer justified.

Although Congress wanted to repeal the ten-year carryback provision completely, it recognized that an immediate, total repeal of the provision "could have an unnecessarily adverse impact upon the deferred tax accounts that such [banks with large net operating losses from the early 1980s] keep for financial and regulatory accounting purposes."<sup>309</sup> So as to lessen any unnecessarily adverse impact, Congress retained a limited version of the ten-year carryback provision. In its repeal of the provision, Congress made an allowance for bad-debt losses of commercial banks and provided that only "the portion of the NOL [resulting from bad-debt loss] for any taxable year beginning *after December 31, 1986 and before January 1, 1994*" could be considered an NOL carryback to each of the preceding ten taxable years prior to the taxable year of such loss.<sup>310</sup>

---

<sup>305</sup> H.R. REP. NO. 99-426, at 592 (1985).

<sup>306</sup> *Id.*

<sup>307</sup> *House Ways and Means Committee Report on the Revenue Reconciliation Act*, TAX NOTES TODAY, Oct. 23, 1987, available at LEXIS, Taxation Library.

<sup>308</sup> See *Ernst and Whinney Study of Tax Reform Provisions Relating to the Financial Services Industry*, TAX NOTES TODAY, Dec. 16, 1986, available at LEXIS, Taxation Library.

<sup>309</sup> *General Explanation of the Tax Reform Act of 1986*, TAX NOTES TODAY, May 10, 1987, available at LEXIS, Taxation Library.

<sup>310</sup> Priv. Ltr. Rul. 99-514 (Oct. 22, 1986) (emphasis added).

Taking into account this allowance, a commercial bank's NOL under the Tax Reform Act of 1986 can be carried back to the preceding ten years only if the loss occurred as a result of bad debt and between the calendar years of 1987 and 1993. Otherwise, under today's provision, a bank's NOL is limited to a carryback of two years or a carryover of twenty years.<sup>311</sup> The revenue effect of this provision was "estimated to decrease fiscal year budget receipts by \$59 million in 1988, \$93 million in 1989, \$92 million in 1990, and \$77 million in 1991."<sup>312</sup>

*c. Reactions to the repeal of the ten-year NOL carryback*

In response to the repeal of the ten-year NOL carryback, the banking community argued that the 1986 amendment was inequitable and untimely. For example, in Cannon's letter to Representative Anderson, Cannon made it clear that he felt that restricting the ten-year carryback provision to bad-debt loss occurring between 1987 and 1993 would harm the commercial banking sector.<sup>313</sup> According to Cannon, the repeal of the ten-year NOL carryback for commercial banks "ignor[ed] the lessons of recent experience [from the 1982-92 housing depression] and . . . could set the stage for crippling housing finance in the United States."<sup>314</sup> On a more general level, Cannon feared that the repeal of the ten-year NOL carryback for commercial banks would "gut the system of tax incentives directed toward helping consumers realize the American dream of home ownership."<sup>315</sup>

*d. Conclusions*

Today, a corporation, regardless of whether it is a financial institution or not, may carry back an NOL suffered in any year to the previous two taxable years and carry it forward and apply it against its taxable income in the next twenty taxable years.<sup>316</sup> After reviewing the legislative history of the enactment and the subsequent repeal of the ten-year NOL carryback provision for commercial banks, it is clear that Congress initially enacted the provision in 1969 in order to provide an extra measure of protection to commercial banks in the event that a particularly harmful bad-debt loss

---

<sup>311</sup> I.R.C. § 172(b).

<sup>312</sup> JOINT COMMITTEE ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (Comm. Print 1987).

<sup>313</sup> 131 CONG. REC. E4100 (daily ed. Sept. 18, 1985) (statement of Rep. Anderson).

<sup>314</sup> *Id.*

<sup>315</sup> *Id.*

<sup>316</sup> I.R.C. § 172(b).

occurred. While Congress' reasons for repealing the general provision are not as clear, it is significant that Congress repealed the provision only after the bad-debt losses of the early 1980s were coming to an end. Moreover, Congress retained the ten-year carryback window for bad-debt losses occurring between the calendar years of 1987 and 1993. However, outside of those narrow parameters, the legislative history makes clear that commercial banks should not continue to be treated differently from other taxpayers in terms of carryback provisions. Thus, an argument could be made that in the event that commercial banks are exposed to a high risk of devastating bad-debt loss at some time in the future, a ten-year NOL carryback provision may be appropriate.

## 2. *Japanese Legislation*

### a. *Suspension of refund of corporate income tax by using the net-loss carryback since 1992*

Similarly to the U.S. tax treatment, Japanese tax law recognizes the carryback and carryforward of "net losses" and the tax deductibility of such losses so carriedback or carriedforward. The definition of a "net loss" under Japanese tax law is similar to the definition of an NOL under U.S. tax law. The CTA defines a net loss as the excess of deductible losses and expenses over gross income. Similarly, the IRC defines a net operating loss as the excess of deductions over gross income for corporations.<sup>317</sup> Pursuant to the basic rule under the CTA, all Japanese corporations, including banks, have been entitled to carry back net losses over a one-year period and to carry them forward for a period of five years. Under this basic rule prescribed in the CTA, a taxpayer corporation may file an amended tax return for the prior year reducing its taxable income for that year by an amount corresponding to the net-loss carryback. In this way, it may be entitled to claim a refund and thereby recoup the corporate income tax that it already paid for the previous year. Any net-loss not used up in offsetting taxable income in the prior year can be carried forward and applied against taxable income from the next five fiscal years. Under the basic rule, a taxpayer corporation can choose to forgo the loss carryback and simply carry the loss forward.

However, the effect of the relevant CTA provisions of the above-mentioned refund has been suspended by virtue of a special tax statute that

---

<sup>317</sup> *Id.* 172(c), (d).

was enacted in 1992 and promulgated as of April 1 of that year.<sup>318</sup> Thus, even today, no Japanese corporation, bank or otherwise, may claim a refund of any part of its corporate income tax paid in connection with a previous fiscal year by carrying back the net-loss that it has suffered in the present year. As a result, net losses may only be carried forward. An exception to this refund suspension exists in cases of dissolution, transfer of a whole business, commencement of reorganization procedures under the Corporation Reorganization Law, or other similar circumstances with respect to a taxpayer corporation. The purpose of this suspension of refund, as proposed by the MOF and NTA, was to raise a portion of the additional tax revenue necessary to reduce the government's huge accumulated financial deficit.

It should be noted that this suspension of refund has been applied since 1992 to financial institutions and non-financial institutions alike, even though the Japanese government itself recognized as early as 1991 the necessity for prompt charge-offs of distressed bank loans resulting from the collapse of the "bubble" economy. Needless to say, this suspension of refund has deprived Japanese banks and other companies of a substantial amount of the tax incentive that used to be given for the prompt charge-off of their distressed loans. This move is strikingly different from the actions the United States adopted for financial institutions during its era of economic hardship for banks and thrifts. The Japanese government has adopted a policy that is diametrically opposed to that of the United States with respect to the issue of the carryback of net operating losses suffered by financial institutions. Ironically, this comes just at the beginning of an unprecedented crisis for Japanese financial institutions.

*b. Anti-major-bank taxation by the Tokyo metropolitan government*

As we have seen, there are very few instances of pro-bank tax legislation in Japan. Instead, a powerful movement for the adoption of anti-

---

<sup>318</sup> The relevant provision of the statute provides as follows:

The provision of Article 81, Paragraph 1 of the CTA (including the case of application *mutatis mutandis* in Article 145, Paragraph 1 of the same Act) shall not apply to a corporation's net-loss amount ("net-loss amount" as defined in Article 2, Item 20 of the same Act; hereinafter the same in this Article) which has arisen in each accounting period which ends during the period between April 1, 1992 and March 31, 2002; except for the deficit amount of the accounting period as stated in Article 81, Paragraph 4 (including the case of being applicable *mutatis mutandis* in Article 145, Paragraph 1; hereinafter the same in this Article) . . .

Sozei tokubetsu sochi hō [Special Tax Treatment Law] art. 66-14 (as amended by Law No.13 of 2000) (Japan).

bank tax legislation has recently emerged on the Japanese political scene, despite the fact that almost all Japanese banks are still struggling to overcome their current financial predicament. For instance, the Tokyo metropolitan government recently enacted a new local tax law,<sup>319</sup> designed to raise about 110 billion yen per year from approximately thirty major banks with branches or offices located within the jurisdiction. This new tax law changes the parameters (i.e., tax base and tax rate) of the existing calculation formula of Tokyo's Enterprise Tax on Corporations (*hōjin jig'yō zei* [*Enterprise Tax*]), which the Tokyo metropolitan government is authorized to impose on all corporations within its jurisdiction under the national tax law. Specifically, under the new law, the Tokyo metropolitan government imposes a three percent<sup>320</sup> Enterprise Tax on the *gross* revenue (before charge-offs of bad loans and other deductible charges) of only those major banks that have aggregate funds of not less than five trillion yen and have a branch or office within the Tokyo metropolitan government's jurisdiction.<sup>321</sup> At the same time, the government imposes a 10% tax on the net profit of other banks and corporations. Under the previous local law, those same major banks were subject to a 10% Enterprise Tax on their income (gross revenue minus loan charge-offs and other deductible charges), just the same as all other business corporations. The major banks had been paying the largest amounts of this previous Enterprise Tax during the "bubble" period because, during that period, the amount of their Enterprise Taxes had been calculated according to their income (net profit), which had reached record highs year after year. This treatment has, however, yielded only meager revenues for Tokyo in recent years. One major reason is that banks that have begun to charge off their huge bad loans that accumulated during Japan's speculative financial bubble and thus decreased their income dramatically. The new treatment is designed to raise approximately 110 billion yen per fiscal year. This amount is the average amount of the previous-type Enterprise Tax collected annually from the banks in question during the "bubble era," without being affected by the amount of charge-offs of their irrecoverable loans. Further, this treatment will apply to those major

---

<sup>319</sup> Tōkyō-to ni okeru ginkō-gyō tō ni taisuru jig'yō-zei no kazei hyōjun tō no tokurei ni kansuru jōrei [Local Tax Act Concerning the Special Treatments Applicable to Corporations Engaging in Banking Business, etc. in the jurisdiction of the Tokyo Metropolitan Government for the Tax Base, etc. Under the Enterprise Tax], Local Act of the Tokyo Metropolitan Government No. 145 of 2000 (Japan) [hereinafter Tokyo Special Bank Taxation Act].

<sup>320</sup> This 3% tax rate is reduced to 2% for certain special financial institutions established under a special statute, such as the Bank of Japan and the Central Bank for Commercial and Industrial Cooperative. See Tokyo Special Bank Taxation Act, *supra* note 320, art. 5.

<sup>321</sup> Tokyo Special Bank Taxation Act, *supra* note 320, art. 3.

banks only from April 1, 2000 through March 31, 2005,<sup>322</sup> the period of time during which the amount of net profits of those banks, after appropriate bad debt deductions, will most likely be nominal because of the projected huge number of distressed loans to be charged-off during such period. Accordingly, this new tax treatment seems to be designed to raise the Enterprise Tax collected from the major banks to an amount higher than ever collected from them by the Tokyo metropolitan government. Thus, this new local tax law will deprive those major banks of one of the major tax incentives for the prompt charge-off of distressed loans.

Bankers and some commentators strongly criticized the Governor of the Tokyo metropolitan government, Shintaro Ishihara, when he made public the proposal for this new local tax law. They argued that the proposal not only oversteps the authority delegated to a local tax law under the national tax law<sup>323</sup> but the proposal also unreasonably discriminates against the banks in question and thus unequivocally violates Article Fourteen of the Japanese Constitution, which assures the right to equal treatment. The Japanese government also published, without precedent, an official statement that questioned the constitutionality and the legality of this new local law given the national tax law.<sup>324</sup>

The Tokyo metropolitan legislature approved, almost unanimously (with only one dissenting vote), the enactment of this new local tax law based on overwhelming support from its constituents, who, like most Japanese, have no sympathy for major banks, which are believed to have long favored corporate clients over individual customers and small businesses. According to a recent poll conducted by a leading newspaper in Japan, 59% of respondents throughout Japan were in favor of this new local tax law proposal and 53% of those polled disagreed with the observation that this new local law was unfair and discriminatory against major banks.<sup>325</sup> The New York Times quoted a banking analyst who stated, "[Governor Ishihara] could have said he was going to tax NEC, Hitachi or Sony, [b]ut banks are an easy target because Japanese like Sony TV's and NEC

---

<sup>322</sup> *Id.*

<sup>323</sup> See Chihō-zei hō [Local Tax Act], Law No. 226 of 1950, art. 72-19 (Japan).

<sup>324</sup> *Kakugi kōtō ryōkai* [Oral Agreement by the Cabinet], Ginkō-gyō ni Taisuru Tōkyō-to no Gaikei Hyōjun Kazei ni tsuite [Re: Tokyo Metropolitan's Proposed Local Tax Law for the Assessment by Estimation on the Basis of the Size of Business to be Applied to Banking Business, etc.], Feb. 22, 2000 (Japan), <http://www.kantei.go.jp/jp/kakugikettei/2000/toukyouto-tihouzei.html> (last visited May 18, 2000).

<sup>325</sup> See To No Gaikei-hyōjun-kazei, "Sansei" 59% [59% support the assessment by estimation on the basis of the size of business to be introduced by the Tokyo metropolitan government], ASAHI SHINBUN, morning edition, Feb. 23, 2000, at 1-2.

computers, but no one really likes Japanese banks.”<sup>326</sup> The Washington Post suggested and the above poll arguably implied that many Japanese disdain bankers as overpaid and reckless businessmen whose lending policies were largely responsible for the financial “bubble” and its subsequent collapse.<sup>327</sup> It has been widely reported that voters were irked that the Japanese government has channeled billions of yen into the major commercial banks in recent years.<sup>328</sup> Moreover, it has also frequently reported that many Japanese customers believe that Japanese banks consistently have offered paltry interest rates to depositors and refused new loans to many promising customers.<sup>329</sup> Governor Ishihara was shrewd enough to take advantage of the usually silent voices of the ordinary Japanese taxpayers to accomplish his political goal of raising necessary funds to shore up the finances of the Tokyo metropolitan government, which is now teetering on the brink of insolvency.<sup>330</sup>

Encouraged by the enactment of this “anti-major banks” local tax law in Tokyo, the ruling party in the legislature of Osaka Prefecture submitted a copy-cat bill for deliberation on March 30, 2000, the exact date of the local tax law’s enactment. This bill was passed in May in the legislature of Osaka Prefecture. This example implies that there is a strong antagonism throughout Japan that could easily lead to the passage of additional anti-bank tax legislation at any moment and might potentially prevent the Japanese government or other local governments from moving to set up any favorable tax treatment for commercial banks.

The first sign of such strong public resentment toward Japanese banks emerged during the enactment of the *jusen* companies “bailout” law<sup>331</sup> in 1996. Given the expected length and magnitude of the *jusen* bad loan clean-up, the Japanese electorate responded vociferously when it was told that the government must bail out the *jusen* housing loan companies for their misguided investments during the bubble era. Japanese citizens have taken the position that *jusen* companies and, among others, the banking industry, were responsible for creating a large portion of the problem and should

---

<sup>326</sup> Stephanie Storm, *Banks React With Shock to a Plan by Tokyo to Tax Profits*, N.Y. TIMES, Feb. 9, 2000, at C4.

<sup>327</sup> See Clay Chandler, *Tokyo Tries to Claim More Bank Revenue*, WASH. POST, Feb. 10, 2000, at E02.

<sup>328</sup> See, e.g., *id.*

<sup>329</sup> See, e.g., *id.*

<sup>330</sup> See, e.g., Storm, *supra* note 326, at C4.

<sup>331</sup> Tokutei jyūtaku kin'yu senmon kaisha no saiken saimu no shori sokushin tō ni kansuru tokubetsu sochi hō [Special Treatment Law Concerning the Expedited Resolution of Debts of Certain *Jusen* Housing Loan Companies], Law No. 93 of 1996 (Japan).

therefore be forced to pay the majority of the clean-up costs.<sup>332</sup> Concerned taxpayers have organized to discuss government bailout proposals and to recommend specific legislative action.<sup>333</sup> As a result, the ruling parties seriously considered the possibility of adopting some anti-bank tax legislation in order to minimize the governmental expenditure for wiping-out those bad debt losses while not directly requiring banks to contribute to the clean-up. The anti-bank tax legislation would include the removal of the 0.3% guaranteed deduction under the General Reserve.

#### IV. DID THE JAPANESE TAX SYSTEM FRUSTRATE THE PROMPT DISPOSITION OF DISTRESSED BANK LOANS?

The above comparative study between the United States and Japanese tax treatments in connection with distressed bank loans during the 1980s and 1990s reveals that in virtually all respects, the United States has been more flexible and generous than Japan with regards to the ability of banks to recognize and to utilize deductible losses with respect to their distressed loans for tax purposes. In particular, under the "Reasonable Business Judgment" doctrine, U.S. banks seem to have been able to enjoy earlier recognition of deductible losses with respect to their troubled loans, as compared with Japanese banks, at least so long as one does not take the existence of the General Reserve system in Japan into consideration.

Although the 0.3% blanket guaranteed deduction under the General Reserve system, which had been maintained up until 1998, had provided Japanese banks with some tax benefits derived from the discrepancy between this 0.3% guaranteed deduction and the bank's actual loan loss ratio until 1991,<sup>334</sup> such tax benefits have been almost completely non-existent since 1993. Moreover, it has been frequently pointed out that, prior to 1993, such blanket guaranteed deduction had provided Japanese banks only with disincentives for facilitating charge-offs or making loss provisions for their non-performing loans.<sup>335</sup> So long as this 0.3% General Reserve covered the bank's aggregate potentially distressed loans, bank management would not

---

<sup>332</sup> See Howard M. Felson, *Closing the Book on Jusen: An Account of the Bad Loan Crisis and a New Chapter for Securitization in Japan*, 47 DUKE L. J. 567, 582 (1997).

<sup>333</sup> See Toshio Aritake, *Japan Releases Data on Bad Debts of Troubled Housing Loan Companies*, BANKING DAILY (BNA), Jan. 22, 1996, available at LEXIS, BNA Library, BNABus File (discussing the creation of the "Association to Ask Banks to Accept Their Responsibility as Creditors").

<sup>334</sup> As frequently pointed out, where the tax rules allow an increase in provision as a deduction from profits but where the total allowable provision is limited to a percentage of loans, as was the case in Japan up until 1998, there is a cash flow benefit to a bank if it increases its loan loss provision up to the allowable amount (although this will reduce earnings and capital). See BEATTIE ET AL., *supra* note 76, at 32.

<sup>335</sup> See, e.g., Okina, *supra* note 86, at 25.



have any incentive to charge off or make loss provisions for those distressed loans in order to improve the bank's financial statements cosmetically. Even if the aggregate amount of those loans had exceeded the 0.3% threshold, the existence of such blanket guaranteed deduction system would arguably have induced bank management to postpone taking a proactive stance with regard to dealing with mounting non-performing loans for the purpose of avoiding any possible attack by shareholders and other stakeholders in the hope that such excess amount might be wiped out by the future tax deductions to be automatically provided under the system. In short, such an automatic blanket deduction system might cause moral hazards for bank management if the bank regulatory agency fails to effectively monitor and supervise the conduct of bank management.

This reluctance of bank management to take any prophylactic measures to deal with the banks' troubled loans might have been amplified by the delay in the introduction of accounting rules providing for the recognition of deferred tax assets in unconsolidated financial statements under the Japanese GAAP. Since the management of Japanese banks has traditionally been inclined to focus on and maintain an ongoing level of reported earnings in their financial statements on an unconsolidated basis, the lack of rules providing for the recognition of deferred tax assets, which would cushion against the full impact of loan loss provisions on reported earnings on an unconsolidated basis, seems to provide a substantial disincentive for banks to establish loan loss provisions for their distressed loans prophylactically before those loans become entitled to the bad debt deduction for tax purposes.<sup>336</sup>

The above comparative study by and large endorses the frequent observation of scholars that the tax regime of the country in which a bank is located is likely to influence the provisioning decisions by the bank management and thus influence the size of loan loss provisions. There is some discretion over the type and size of provisions in most countries. In exercising such discretion, banks may charge off their bad loans and make loan loss provisions in such a way as to improve earnings, regulatory capital and cash flow as much as possible.

On balance, the tax regime of Japan has provided less adequate tax incentives for banks to expedite the disposition of their bad loans<sup>337</sup> than the tax regime of the United States. The difference in the speed and promptness of charge-offs of distressed loans between U.S. banks and Japanese banks

---

<sup>336</sup> See *supra* Part III.C.

<sup>337</sup> See Kanaya & Woo, *supra* note 11, at 11.

seems to be attributable, at least partially, to the differences between the U.S. and Japanese tax treatments for troubled loans. For instance, while the total amount of assets past due ninety days or more, together with assets in non-accrual status, held by FDIC-insured U.S. commercial banks amounted to \$76.98 billion dollars as of the end of December 1991, the total amount of loan assets past due ninety days or more, together with loan assets from bankrupt entities, held by city banks in Japan was reported as 8455 billion yen as of the end of March 1993. On the other hand, the aggregate amount of net loan and lease charge-offs of all FDIC-insured U.S. commercial banks during 1992 through 1994 reached \$54.14 billion dollars (70.33% of the above aggregate amount of distressed assets as of December 1991). Meanwhile, the aggregate amount of loan charge-offs (including net additions to the Special Depreciation Account) of city banks in Japan during 1993 through 1995 reached 5825 billion yen (68.89% of the above aggregate amount of distressed assets as of March 1993). Note, however, that the above figure for the aggregate amount of loan charge-offs of Japanese city banks does not incorporate appropriate netting-outs (i.e., that the amount of loans for which some reserves to the Special Depreciation Account were first established and thereafter were specifically charged off within the relevant period is double-counted and loan recovery is not taken into account in the calculation of such figure). Thus, it would be reasonable to conclude that U.S. banks had been disposing of their distressed loans more quickly than Japanese banks, at least up until the mid 1990s. Since the Japanese tax system provided less adequate tax incentives than that of the United States at least up until the 1998 Amendments, the management of Japanese banks had arguably been less strongly motivated to charge-off their banks' distressed loans under the Japanese system.

## V. CONCLUSION

Surprisingly enough, in both the United States and Japan, there has so far been no comprehensive comparative study highlighting the tax treatments for distressed bank loans in these two economically powerful countries.<sup>338</sup> Moreover, a number of commentators<sup>339</sup> (including those at the MOF)<sup>340</sup> have argued that Japanese tax treatments seem to be more generous for banks and other financial institutions than those of the United States. This argument is based principally upon the fact that since 1986 the United

---

<sup>338</sup> As one of the preliminary studies in this area, see Yoshida, *supra* note 61.

<sup>339</sup> *Id.* at 57.

<sup>340</sup> See TAKAHASHI, *supra* note 96, at 12.

States, unlike Japan, has not allowed any deduction for major banks with respect to their loan loss reserves.

Detailed and multi-dimensioned analyses on the actual case precedents and tax practices in both countries reveal that Japanese tax treatments of distressed bank loans are, by and large, *less* favorable than U.S. treatments, as we have seen in the foregoing. This may well partially be the result of the strong resentment felt by the public toward commercial banks in Japan.<sup>341</sup> It is argued that this seems to be the outcome of the strong influence exerted by powerful banks (through the so-called "main bank system") on Japanese industry.<sup>342</sup> Such public resentment has been amplified by the frenzy of speculation in stocks and real estate that Japanese banks allowed, and even encouraged, during the 1980s. With a negative predisposition vis-à-vis commercial banks firmly fixed in the minds of the Japanese public, the Japanese government seemed to respond by taking a rigorous position in its tax treatment of distressed bank loans. Such governmental policy partially deprived Japanese banks of their tax incentives for the prompt and voluntary charge-off of their distressed loans. In addition, variations in tax treatments for distressed bank loans between the United States and Japan, together with different approaches to the recognition of deferred tax assets in unconsolidated financial statements up until 1998, imply that there are differences between these two countries in the consequences of establishing loan loss reserves for financial institutions' earnings and capital.

It is vital for Japan to harmonize its overall corporate income tax treatments with those of the United States, including those applicable to distressed bank loans. This would establish a level playing field for Japanese banks to compete with U.S. banks in the global market. In addition, it would help Tokyo's financial and equity markets keep up with markets in New York and other world markets. Japan must, therefore, develop a workable tax scheme for dealing with distressed bank loans, one that will be consistent with that of the United States and that can be introduced into the existing Japanese framework for corporate income tax without creating serious practical difficulties. Of course, the U.S. model is not the only model that the Japanese system could follow. However, considering that both the U.S. corporate income tax system and the Japanese corporate income tax system adopt the concept of *Haig-Simons* income as

---

<sup>341</sup> See Part III.G.2.b.

<sup>342</sup> For a discussion of this strong influence through "main bank system," see generally PAUL SHEARD ET AL., *NIHON NO MEIN BANKU SISUTEMU* [MAIN BANK SYSTEM IN JAPAN] (Masaki Shiratori et al. trans., 1996).

their key concept,<sup>343</sup> the Japanese system for bank taxation should follow that of the United States so long as the U.S. system is moving in a direction that is consistent with the global trend towards mark-to-market accounting<sup>344</sup> and uniform capital adequacy rules for financial institutions. Since the most powerful and influential competitors of Japanese banks are currently U.S. banks, following the U.S. system provides the best opportunity to level the playing field of competition between Japanese and U.S. banks in the global market.

In addition, it should be noted that tax academics and practitioners have recently placed more emphasis on the increasing need for the harmonization of corporate income tax rules to eliminate the distortion of business activities and the inefficient distribution of resources in the era of globalization.<sup>345</sup> The necessity for a harmonized global income tax system has been advocated more strongly in the area of the commercial banking business than in other businesses because of the global trend toward mark-to-market accounting rules,<sup>346</sup> and the recent move toward more uniform capital adequacy rules for bank regulatory purposes<sup>347</sup> resulting from a surge in trans-border financial transactions. In order to provide an arena for global competition in which all financial institutions of the world are put on an equal footing, harmonized capital adequacy rules, which are designed to provide both security to the banking system and to create a level playing field in which banks can operate,<sup>348</sup> must be formulated, as well as a harmonized corporate income tax system for financial institutions.<sup>349</sup>

With these considerations in mind, what kind of approach should be adopted for the reform of the Japanese corporate income tax system? One promising direction would be to move the Japanese corporate income tax system closer to a model of measuring income based on "economic income" or *Haig-Simons* income by means of a mark-to-market system, especially for the tax treatment of distressed bank loans. It has been repeatedly pointed out

---

<sup>343</sup> See *supra* Part II.A.

<sup>344</sup> See Kin'yū Shōhin Ni Kakaru Kaikei Kijun [Accounting Standards With Respect to Financial Products] (Kigyō Kaikei Shingikai [Business Accounting Council] 1999). See also Financial Instruments: Recognition And Measurement, International Accounting Standards (IAS) No. 39 (International Accounting Standards Committee 1998); Accounting For Certain Investments In Debt And Equity Securities, Statement of Financial Accounting Standards No. 115 (Financial Accounting Standards Bd. 1993).

<sup>345</sup> See, e.g., KANEKO, *supra* note 32, at 97-98.

<sup>346</sup> See *supra* note 344.

<sup>347</sup> See *supra* note 27 and accompanying text.

<sup>348</sup> See *id.*

<sup>349</sup> Although there is a move to harmonize capital adequacy rules, the lack of harmonization of tax and accounting rules suggests that banks are not yet competing on a level playing field on a worldwide basis. BEATTIE ET AL., *supra* note 76, at 32.

that improving the measurement of taxable income is an integral step in promoting fairness by treating taxpayers in an evenhanded manner.<sup>350</sup> It has also been frequently argued that improving the measurement of income also increases the economic neutrality, as well as the economic efficiency, of the tax system by reducing disparities in treatment between various investments and industries under the tax law.<sup>351</sup> Given the strength of the proposition that measuring taxable income based upon *Haig-Simons* income through a mark-to-market system may achieve a relatively optimal income taxation in light of considerations of fairness and neutrality,<sup>352</sup> it is desirable for the Japanese income tax system to apply the mark-to-market approach in measuring taxable income to as many areas as possible.

Based upon the above analysis, one could interpret the 1998 Amendment as an integral step in revising the tax system for distressed bank loans in accordance with the mark-to-market approach.<sup>353</sup> It eliminated the restrictions on the deductibility of partially worthless loans for income tax purposes<sup>354</sup> and thus removed one of the major restrictions on the deductibility of distressed bank loans that are inconsistent with the mark-to-market approach. The introduction of the mark-to-market approach in the assessment of financial assets held by financial institutions for the purpose of tax accounting in April 2000<sup>355</sup> was also an important move toward the expansion of the mark-to-market approach in the Japanese corporate income tax system.

These moves lack, however, the necessary "finishing touches" since a mark-to-market assessment cannot be used at all in the appraisal of ordinary loan assets for the purpose of income tax accounting. As mentioned above, under the U.S. tax law, banks and other financial institutions may, to some extent, accelerate their deductions for tax purposes with respect to a loan's decrease in market value by marking such loan to the market. It is clear that such treatment offers banks and financial institutions more tax incentives to charge off or otherwise dispose of their distressed loans and thus could

---

<sup>350</sup> See, e.g., NAKAZATO, *supra* note 50, at 77.

<sup>351</sup> See, e.g., U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH, 126-30 (1984); THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 1, 202 (1985).

<sup>352</sup> Although this article is not intended to examine the legitimacy of this proposition, it should be noted that in both the United States and Japan, this proposition has become pervasive and gradually been reflected in their respective actual tax legislations in recent years. See Evans, *supra* note 44, at 825; Nakazato, *supra* note 44, at 29; NAKAZATO, *supra* note 50, at 55-60, 62-79.

<sup>353</sup> See RYŌJI TAKEDA, *Sonkin, Ekikin no Ninsiki, Sokutei* [Recognition and Measurement of Deductible Losses and Taxable Incomes], 51 KIGYŌ KAIKEI 108, 115.

<sup>354</sup> See *supra* Part III.B.1.a.

<sup>355</sup> See *supra* Part III.D.2.

facilitate the improvement of their financial conditions. From this perspective, the Japanese legislature and tax authority should adopt tax treatment provisions similar to those set forth in Section 475 of the IRC. In this regard, Article 33, Paragraph 2 of the CTA, pursuant to which the NTA has taken a stringent position with respect to the tax deductibility of a partially-worthless loan and has seemed to have adopted the Necessity for the Liquidation of All Assets of the Debtor theory, should be eliminated. This provision had lost all of its rationale by the time the latest "after markets" for loan assets emerged in Japan in the late 1990s,<sup>356</sup> and is no longer consistent with the current GAAP in Japan, which, in principle, employs a mark-to-market approach in assessing financial assets.<sup>357</sup> Obviously, Japanese accounting rules for banks have been rapidly moving in the direction of marking to market.<sup>358</sup> Article 33, Paragraph 2 of the CTA has become quite inconsistent with this move and has, to some extent, deprived Japanese banks of tax incentives to expedite the disposition of their distressed loans and circumvent unnecessary tapping-out of their retained earnings. Further, the provision has been abused by the Japanese tax authority as one of the theoretical tools employed to unreasonably disapprove the prompt recognition by banks and other financial institutions of tax losses for their distressed loans. Accordingly, in order to procure a level playing field for competition between Japanese and U.S. banks and to move the Japanese income tax system closer to a model of measuring income based on *Haig-Simons* income, the elimination of this provision should be effected quickly.

In addition, the revival of the "conformity rules" should be considered on the condition that the bank regulatory power becomes completely independent of the MOF and thus the conflict of interest between bank regulatory purposes and tax purposes created by the single administration under the MOF is eliminated. The U.S. experience in the last twenty years has proved the effectiveness of "direct" tax incentives for bad debt deductions obtained through the U.S.-type "conformity rule" and its facilitation of charge-offs of distressed bank loans. Alternatively, if it is practically difficult for the Japanese tax authority to adopt the U.S.-type "conformity rule" without any assurance of procuring necessary tax

---

<sup>356</sup> See *supra* Part III.B.1.b.

<sup>357</sup> See *supra* note 344 and accompanying text.

<sup>358</sup> Japanese banks began disclosing unrealized capital gains on securities in 1990 in accordance with accounting rules established by the Federation of the Bankers Associations of Japan. In addition, the MOF Securities Bureau has required banks that are subject to the disclosure requirements of the Securities and Exchange Law to disclose such gains since December 1990. SCOTT & IWAHARA, *supra* note 27, at 43.

revenues to cover governmental expenditures, the adoption of the following proposal for minimizing the administrative burdens entailed by the review of worthlessness of distressed loans by the tax authority might be worthy of further consideration. The content of such proposal is as follows: (1) allow taxpayers to deduct bad debts whenever they are charged off for financial accounting purposes; (2) impose income taxes on any recoveries of deducted debts at the higher of the taxpayer's marginal rate in the year of the deduction and that in the year of the recovery; and (3) assess an interest charge on this income tax from the time of the deduction to the time of recovery.<sup>359</sup>

Further, whenever economically necessary, the suspension of anti-bank legislation and introduction of pro-bank legislation with a limited duration period should be considered on timely basis. A comparative study between the impact of the pro-bank tax legislation in the United States during the period from 1976 through 1993 and that of the anti-bank tax legislation in Japan in recent years<sup>360</sup> seems to suggest the necessity of deliberate and rational consideration in a broader perspective on this point.

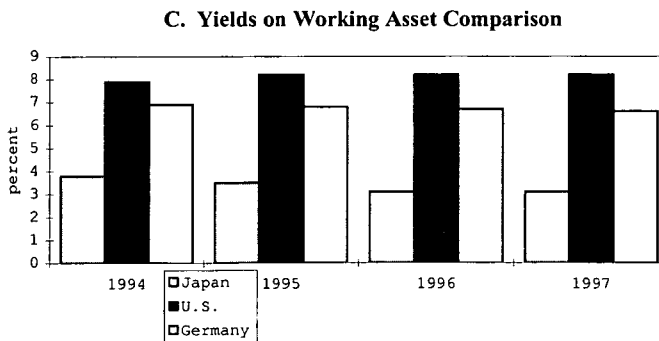
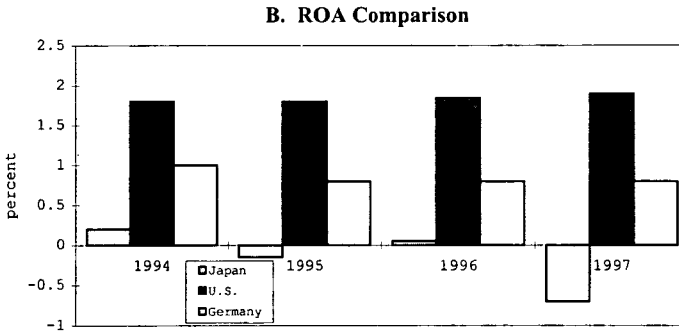
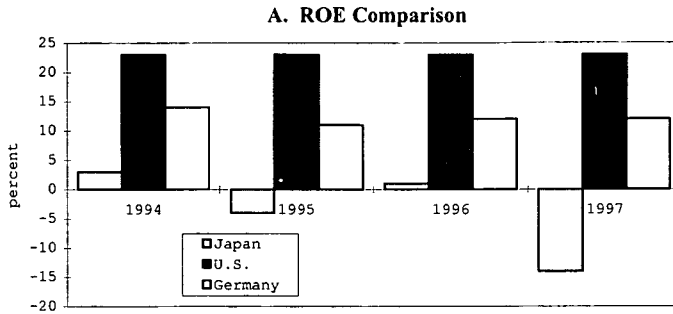
In any event, in this era of globalization, the need for the constant review and adjustment of tax treatments in accordance with global trends will continue to increase, especially in the area of distressed bank loans as well as other matters. Furthermore, the tax treatments must be based upon a wide range of perspectives derived from tax, accounting, and financial market regulatory systems.

---

<sup>359</sup> Am. Tax'n Ass'n Comm. on Income Measurement, *A Time Value of Money Approach to Bad Debts*, 40 TAX NOTES 1075 (1988).

<sup>360</sup> See *supra* Part III.G.

### Appendix 1: ROE, ROA and Yields Comparison<sup>361</sup>



<sup>361</sup> Kanaya & Woo, *supra* note 11, at 23.



## APPENDIX 2: SUMMARY OF THE U.S. TAX TREATMENTS FOR RESTRUCTURING OF TROUBLED LOANS<sup>362</sup>

### Alterations Pursuant To Terms Of The Debt

Instrument	Modification?	If So, Significant?
Generally .....	No	-
Substitution of obligor .....	Yes	Nonrecourse-no; recourse-yes, unless exception
Addition/Deletion of co-obligor .....	Yes	Only if change in payment expectations
Recourse to nonrecourse .....	Yes	Yes, unless exception
Nonrecourse to recourse .....	Yes	No
Reclassification of debt instrument as equity .....	Yes	Yes
Conversion of debt to equity		
by obligor .....	Yes	Yes
by holder .....	No	-
Exercise of option other than conversion option, either not unilateral, of by holder to defer/reduce interest/principal .....	Yes	See Alterations Other Than Pursuant To Terms Of The Debt Instrument, below
Exercise of option, other .....	No	-
Failure to exercise option .....	No	-
Other alterations pursuant to terms (general rule) .....	No	-

### Alterations Other Than Pursuant To Terms Of The Debt Instrument

Change in yield .....	Yes	Within .25%/5% threshold-no; not within-yes
Timing of payments .....	Yes	=/<5yrs/50% original term-no >above period-facts & circumstances
Failure to perform .....	Yes, if holder agrees and forbearance exceeds 2+year safe harbor No, otherwise.	See "Timing of payments" above
Substitution of obligor .....	Yes	-
Addition of co-obligor .....	Yes	Nonrecourse-no; recourse-yes, unless exception
Recourse to nonrecourse .....	Yes	Only if change in payment expectations
Nonrecourse to recourse .....	Yes	Yes, unless exception
Change in security .....	Yes	No
for nonrecourse		
for recourse		
Change in priority .....	Yes	If substantial change Only if change in payment expectations
Conversion of debt to equity .....	Yes	Only if change in payment expectations
Reclassification of debt to equity .....	Yes	Yes, generally
Change in customary accounting & financial covenants .....	Yes	Yes, generally No

<sup>362</sup> This table is an excerpt of the table that appears in Bravenec & Hurr, *supra* note 272, at 376.